The Honorable Marsha J. Pechman

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

IN RE WASHINGTON MUTUAL, INC. SECURITIES, DERIVATIVE & ERISA LITIGATION	No. 2:08-md-1919 MJP
This Document Relates to: *Flaherty & Crumrine Preferred Income Fund Incorporated, et al. v. Killinger, et al.*, No. C09-1756 MJP	FLAHERTY & CRUMRINE PLAINTIFFS' CONSOLIDATED OPPOSITION TO DEFENDANTS' MOTIONS TO DISMISS THE AMENDED COMPLAINT ORAL ARGUMENT REQUESTED

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

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Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

TABLE OF AUTHORITIES

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

STATUTES, RULES AND REGULATIONS

SECONDARY AUTHORITY

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

Plaintiffs, Flaherty & Crumrine Preferred Income Fund Incorporated, Flaherty & Crumrine Preferred Income Opportunity Fund Incorporated, Flaherty & Crumrine/Claymore Preferred Securities Income Fund Incorporated, Flaherty & Crumrine/Claymore Total Return Fund Incorporated, and Flaherty & Crumrine Investment Grade Fixed Income Fund (collectively, "Flaherty & Crumrine" or "F&C"), respectfully submit this Consolidated Opposition to Defendants' Motions to Dismiss the Amended Complaint.[1] For the reasons set forth herein, the Court should deny Defendants' motions.[2]

I. INTRODUCTION

Flaherty & Crumrine seeks redress for injuries suffered as a result of the collapse of Washington Mutual, Inc. (referred to herein, along with its subsidiaries, as "Washington Mutual" or WaMu") – the largest bank failure in United States history. F&C purchased Washington Mutual unregistered preferred securities that are now essentially worthless. In purchasing the securities, F&C relied upon many of the same false and misleading statements held to be actionable in the related class case. However, the class case does not cover claims in connection with the purchase of unregistered Washington Mutual securities. Therefore, F&C initiated the current individual action and asserts two distinct sets of claims: 1) negligence claims (against all Defendants); and 2) fraud–based claims (only against the Officer Defendants).

Unable to attack the sufficiency of the substantive factual allegations leveled against them, Defendants argue that F&C failed to plead basic elements of its claims; however, Defendants simply ignore the allegations in the Amended Complaint.

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[1] "Defendants" refers to: Kerry K. Killinger, Thomas W. Casey, Stephen J. Rotella, Ronald J. Cathcart, David C. Schneider (collectively referred to as the "Officer Defendants"); Anne V. Farrell, Stephen E. Frank, Thomas C. Leppert, Charles M. Lillis, Phillip D. Matthews, Regina Montoya, Michael K. Murphy, Margaret Osmer McQuade, Mary E. Pugh, William G. Reed, Jr., Orin C. Smith, James H. Stever, Willis B. Wood, Jr. (collectively referred to as the "Director Defendants" and together with the Officer Defendants, collectively referred to as the "Individual Defendants"); and Goldman, Sachs & Co., Credit Suisse Securities (USA) LLC, and Morgan Stanley & Co. (collectively referred to as the "Initial Purchaser Defendants").

[2] In order to streamline the current action and preserve judicial resources, F&C agrees to voluntarily dismiss without prejudice its claims for constructive fraud pursuant to Cal. Civ. Code §1573 in Count II, Count III (negligence), Count IV (common law aiding and abetting), and its claims for violations of Cal. Corp. Code §25504 in Count VI.

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

For instance, Defendants move to dismiss F&C's fraud and negligent misrepresentation claims by asserting that F&C did not plead reliance on any of the alleged false and misleading statements. Contrary to this argument, F&C alleges actual detrimental reliance. *See infra* §V.A & C. Unsurprisingly, F&C – a "sophisticated" institutional investor – actually read the false and misleading statements at issue and adequately pleaded that it relied on them when making investment decisions.

Instead of arguing a lack of actual reliance, the Initial Purchaser Defendants assert that boilerplate "disclaimers" in the offering documents demonstrate the Initial Purchaser Defendants did not make the statements contained in the Offering Circulars, thereby negating any justifiable reliance and requiring the Court to dismiss F&C's negligent misrepresentation claim under California law. The Initial Purchasers' argument ignores F&C's well-pleaded allegations that the Initial Purchaser Defendants did in fact make these statements; and, the Initial Purchasers' argument is contrary to the great weight of authority analyzing such boilerplate disclaimers. Further, California law specifically rejects attempts to limit liability in the manner attempted by the Initial Purchaser Defendants. *See infra* §V.C.2.b.

Goldman Sachs seeks to dismiss California securities law claims analogous to §12(a)(2) claims under the Securities Act of 1933, which this Court has already upheld in the consolidated securities class action. Goldman Sachs' affirmative defense, that it conducted a reasonable investigation, is not suited for determination on a motion to dismiss and is clearly contradicted by the well-pleaded allegations of rampant "red flags" indicating the statements in the Offering Circulars were false and misleading. *See infra* §V.B.1.b. Moreover, Goldman Sachs asserts *ipse dixit* – and contrary to the well-pleaded allegations – that the securities F&C purchased were not offered or sold in California. Goldman Sachs posits an incorrect ***factual*** argument, contrary to the well-pleaded allegations that all of F&C's investment decisions and trade activity were conducted through F&C's California headquarters and the Initial Purchaser Defendants solicited F&C in California to participate in the offerings. *See infra* §V.B.1.a.

Finally, the Initial Purchaser Defendants go so far as to claim that F&C's action must be dismissed because it alleges no economic loss. Incredibly, the Initial Purchaser Defendants argue that

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

F&C suffered no damages because it received all dividend payments until Washington Mutual fell into bankruptcy – essentially asserting that the securities had no independent worth, but for the value of their distributions. Not only is this argument contradicted by the fact that the securities were purchased for valuable consideration, and are now worth virtually nothing, but California law delineates the scope of allowable damages under both the common law and its securities code to include recovery based on purchase price inflation, which F&C alleges in connection with its claims against the Initial Purchaser Defendants. *See infra* §V.D.

In sum, Defendants' arguments in favor of dismissal are contrary to F&C's well-pleaded facts, contradict applicable federal and state law, and are inconsistent with this Court's prior holdings. Therefore, F&C respectfully requests that the Court deny Defendants' motions.

II. PROCEDURAL HISTORY

On May 7, 2008, the Court consolidated three related securities class actions as part of a Multi-District Litigation proceeding against Defendants. Defendants filed their first round of motions to dismiss on December 8, 2008, and the Court heard argument on these motions on May 1, 2009. On May 15, 2009, the Court dismissed claims pursuant to §§10(b) and 20(a) of the Exchange Act of 1934 without prejudice and granted in part and denied in part claims pursuant to §§11, 12, and 15 of the Securities Act of 1933. The class action plaintiffs alleged actionable misrepresentations concerning underwriting standards, internal controls, and reserves for anticipated loan losses. *In re Wash. Mut., Inc. Sec. Litig.*, 259 F.R.D. 490, 497-501 (W.D. Wash. 2009) ("*WaMu I*").

Specifically, the class plaintiffs alleged that the October 2007 public offering documents represented that "'The Company … ensure[s] compliance with its underwriting standards'" to mitigate and manage credit risk. *Id*. at 505.[3] Class plaintiffs asserted that this statement was "'materially false and misleading because the Company was, in fact, lowering its underwriting standards and issuing loans that were increasingly unlikely to be repaid.'" *Id*. Class plaintiffs alleged that WaMu employed

[3] All internal citations and quotations are omitted, and all emphasis has been added, unless otherwise noted.

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

"'extremely loose underwriting guidelines'" to which it "'routinely allowed exceptions.'" *Id*. The class plaintiffs further asserted that exceptions to the underwriting guidelines were "'part of the norm'" and "'[t]here were really no restrictions to approve a loan.'" *Id*.

The Court found that these allegations contradicted WaMu's representation that it was mitigating credit risk through compliance with its underwriting standards, and indicated that WaMu was instead increasing credit risk by loosening and ignoring its underwriting standards. *Id*. Therefore, the Court held that the class plaintiffs' allegations sufficiently "'set forth what is false or misleading about [the] statement, and why it is false'" reasoning that if WaMu's lending environment was fraught with such extreme departure from any plausible conception of "'standards,'" a statement that the Company followed underwriting standards to manage or mitigate credit risk would mislead a reasonable investor. *Id.* at 505-06.

Similarly, the class plaintiffs alleged that the October 2007 public offering documents falsely represented that: (1) "'[M]anagement believes that … the Company maintained effective internal control over financial reporting[;]'" and (2) "'Management reviews and evaluates the design and effectiveness of the Company's internal control over financial reporting on an ongoing basis … and changes its internal control over financial reporting as needed to maintain their effectiveness, correcting any deficiencies, as needed, in order to ensure the continued effectiveness of the Company's internal controls.'" *Id*. at 506. Further, the class plaintiffs alleged that Defendants misrepresented in the October 2007 public offering documents that WaMu periodically adjusted its internal controls to maintain their effectiveness. *Id*. The class plaintiffs alleged these statements to be false because the Company's Loan Performance Risk Model ("LPRM"), "the key model used by the Company to predict losses,'" failed to account for the high credit risk presented by WaMu's Option ARM loans and other loans allowing for negative amortization. *Id*. According to the class plaintiffs, "'as of summer 2007, the LPRM had not been calibrated to reflect actual loan performance data for over ***eighteen months***.'" *Id*. (emphasis in original). In addition, class plaintiffs contended that Defendants intentionally decreased the effectiveness of WaMu's risk management group during the Class Period, assigning risk management personnel a "'secondary "support" role to loan production[.]'" *Id*. In removing controls

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

against risky lending, WaMu allowed a single officer to occupy two roles with conflicting purposes, as the supervisor of both the risk management personnel and the home lending operations. *Id*.

The Court held that these allegations explained with particularity why the alleged misrepresentation concerning internal controls in WaMu's October 2007 public offering documents were both false and misleading. WaMu's representation that it continually updated its internal controls to maintain their effectiveness was specifically contradicted by allegations that the Company intentionally decreased the regulatory power of the risk management group during the Class Period and failed to update its systems for predicting credit risk. Therefore, the Court held that the class plaintiffs stated a claim under §§11 and 12(a)(2) against all Securities Act Defendants as to the October 2007 public securities offering. *Id*.

On October 16, 2009, F&C filed this action in the Superior Court of the State of California, County of Los Angeles.

On October 27, 2009, the Court issued an order on Defendants' renewed motions to dismiss. *In re Wash. Mut., Inc. Sec. Litig.*, 2:09-md-1919 MJP, 2009 U.S. Dist. LEXIS 99727 (W.D. Wash., Oct. 27, 2009) ("*WaMu II*"). The Court concluded that class plaintiffs remedied most of the deficiencies of their initial complaint. *Id.* at *17-*53. As to Defendant Killinger, the Court concluded nearly all of the §10(b) claims were adequately pleaded regarding false statements concerning risk management, appraisals, underwriting, financial statements, and internal controls, except for two statements. *Id*. Concerning Defendants Casey, Rotella, Cathcart, and Schneider, the Court held that the class plaintiffs' §10(b) claims were adequately pleaded as to all five areas of false statements, and, in large part, denied Defendants' motions to dismiss. *Id*.

On November 2, 2009, Defendants removed this action to the U.S. District Court for theCentral District of California. On December 12, 2009, the Judicial Panel on Multidistrict Litigation issued an order transferring the case to this Court. F&C filed their Amended Complaint on January 25, 2010, which Defendants now seek to dismiss.

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III. STATEMENT OF FACTS

A. Summary of the Action

F&C purchased unregistered Washington Mutual Preferred Funding Trust I Fixed-to Floating Rate Perpetual Non-cumulative Trust Securities ("Preferred Trust Securities") issued on March 7, 2006 (the "2006 Offering") and October 25, 2007 (the "2007 Offering"), pursuant to the offering documents F&C received from Defendants (the "Offering Circulars"), which also expressly incorporated by reference additional statements made in, among other things, Washington Mutual's filings with the United States Securities and Exchange Commission ("SEC"). ¶¶1, 4, 24.[4]

The Offering Circulars and incorporated documents misrepresented critical elements of Washington Mutual's business practices and financial condition, which had a material impact upon Washington Mutual's creditworthiness and the suitability of Plaintiffs' investment in the Preferred Trust Securities. ¶6. F&C read and relied upon the Offering Circulars and the documents incorporated by reference, as well as analyst reports and credit ratings agency reports concerning Washington Mutual that repeated and/or relied upon Defendants' false and misleading statements. ¶¶4, 24.

F&C was damaged by Defendants' fraud (Count I against the Officer Defendants ¶¶245-52), violations of California's civil and securities laws (Counts II, V and VI against the Officer Defendants ¶¶253-60, 274-80, and 281-86; and Count VI against Goldman Sachs, ¶¶281-86), negligent misrepresentations (Count IV against all Defendants, ¶¶266-73) and violations of the federal securities laws (Counts VIII and X against the Officer Defendants, ¶¶292-300, and 310-17; Count IX against the Officer and Director Defendants, ¶¶301-09; and Count XI against the Director Defendants, ¶¶318-24).

B. WaMu Disregarded Prudent Underwriting and Appraisal Practices

Loans originated by WaMu were retained by the Company as an investment, securitized, or sold to third-party investors. ¶53. When WaMu sold or securitized loans, WaMu provided purchasers of its mortgage loans with representations and warranties regarding the underwriting and appraisal standards the Company followed in originating the loans. ¶55. Compliance with underwriting and appraisal

[4] All "¶__" and "¶¶__" references are to the Amended Complaint, unless otherwise noted.

standards, and the credit quality of the loans WaMu originated, were critically important to the Company's financial condition because WaMu was obligated to repurchase or otherwise compensate purchasers of loans originated by WaMu that suffered an early default or that did not comply with stated underwriting and appraisal standards. ¶56.

Beginning in 2003, WaMu's senior executives, including the Officer Defendants, crafted a radical new business strategy that was intended to boost profits. The new WaMu used huge sales commissions and misleading marketing to push risky and overpriced loans to borrowers. ¶58. According to WaMu's former employees, the scheme to inflate loan volume was directed by WaMu's senior management. ¶¶61, 71, 72. "'[P]ressure to keep lending emanated from the top, where executives profited from the swift expansion [including] Kerry K. Killinger, who was WaMu's chief executive from 1990 until he was forced out in September [2008].'" ¶¶26, 71. According to a former WaMu senior risk manager, WaMu began approving as many loans as it could. "'Everything was refocused on loan volume, loan volume, loan volume.'" ¶62. As set forth in the accounts of numerous former WaMu employees, WaMu lenders and underwriters "'felt pressure to sell as many loans as possible and push risky but lucrative loans onto all borrowers.'" ¶60. Interviews with two dozen former employees, mortgage brokers, real estate agents and appraisers also revealed the relentless pressure to churn out loans which caused bank's meteoric rise and its precipitous collapse in the biggest bank failure in American history. ¶68.

According to former WaMu employees, by no later than 2005 WaMu had abandoned appropriate and customary underwriting standards in order to artificially inflate loan volume. ¶66. WaMu pressed sales agents to pump out loans while disregarding borrowers' incomes and assets, according to former employees. *Id*. Similarly, WaMu pressured appraisers to provide inflated property values that made loans appear less risky, enabling Wall Street to bundle them more easily for sale to investors. *Id*. According to a founder of an appraisal company that did business with WaMu until 2007, "'It was the Wild West … [i]f you were alive, they would give you a loan. Actually, I think if you were dead, they would still give you a loan.'" ¶69.

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C. False and Misleading Assurances to Investors Prior to the 2006 Offering

Although WaMu had abandoned all prudent underwriting standards by no later than 2005 (¶¶59-78) on March 14, 2005, Defendants Killinger, Casey, Farrell, Frank, Matthews, Murphy, Osmer McQuade, Pugh, Reed, Stever, and Wood, told investors in WaMu's Form 10-K for the quarter and year ended December 31, 2004, that WaMu utilized underwriting procedures to mitigate loan losses in its subprime loan portfolio: "'We seek to mitigate the credit risk in this portfolio by re-underwriting all purchased subprime loans.'" ¶¶143, 144.

About six months later, on October 19, 2005, WaMu issued a press release announcing its financial results for the quarter ended September 30, 2005. This press release was expressly incorporated by reference into the 2006 Offering Circular, dated February 24, 2006 ("2006 Offering Circular"). ¶147. In this press release, WaMu "'announced third quarter 2005 net income of $821 million, or $0.92 per diluted share, up 21 percent on a per share basis when compared with net income of $674 million, or $0.76 per diluted share, in the third quarter of 2004.'" *Id*. These financial results were false. Generally Accepted Accounting Principles ("GAAP") required WaMu, including the Officer Defendants and the Director Defendants on WaMu's audit committee, to establish a reserve for incurred credit losses resulting from borrowers defaulting on their obligations to make monthly mortgage payments or when it was probable that borrowers would do so (the "Allowance for Loan and Lease Losses" or "Allowance"). ¶93. WaMu and the Officer and Director Defendants on the audit committee understated the Allowance by not properly taking into consideration the deteriorating credit quality of the Company's loan portfolio resulting from the abandonment of appropriate underwriting and appraisal practices. By doing so, the Officer Defendants, the Director Defendants on the audit committee and WaMu overstated WaMu's net income and earnings per share. ¶96.

In the same press release, Defendant Killinger characterized the Company's performance as "'solid'" and lauded the Company's "'continued focus'" on risk management. ¶147. On that same day, during a conference call with investors, WaMu Chief Executive Officer Killinger declared, "'we believe we can effectively manage our credit quality by continuing to be disciplined and vigilant in our underwriting standards, our portfolio management, and our reserving methodology.'" ¶148. WaMu

Chief Financial Officer Casey claimed: "'Our credit performance continues [to be] very good. … We continue to proactively manage our credit risk, and are taking steps now to reduce potential future exposure.'" *Id*. They knew these statements were false because the Officer Defendants received a September 2005 confidential Corporate Risk Oversight Report which identified deficiencies in WaMu's internal controls and computer modeling that the Company never properly addressed. ¶63. According to the "Corporate Risk Oversight Report," WaMu's own risk management team found that the future performance of popular loans like Option Adjustable Rate Mortgages ("ARMs") was "untested" and created "major and growing risk factors in our portfolio." ¶63.

By no later than Fall 2005, WaMu senior executives, including the Officer Defendants, actively discouraged WaMu's risk managers from performing their responsibilities, purposefully dissuading risk managers from raising meaningful issues or negative findings. ¶65. Shortly thereafter, in the Fall of 2005, WaMu's chief compliance and risk-oversight officer made it clear that "'[t]hey weren't going to have risk management get in the way of what they wanted to do, which was basically lend the customers more money,'" according to Dale George, a senior credit-risk officer. ¶64. Despite this knowledge, on November 15, 2005, Defendant Killinger told attendees of WaMu's Investor Day conference: "'On credit risk. We have excellent processes, policies, underwritings, standards and reserving methodologies in place and they have served us very well for quite some time.'" ¶155. And Defendant Schneider lied when he said that "'In addition, we've maintained effective risk management processes. This is clearly a top priority for us. We've invested a significant amount in terms of talent and technology in building risk management[.]'" ¶156.

D. The False and Misleading 2006 Offering Documents

Goldman Sachs, Credit Suisse and Morgan Stanley sold $1.25 billion of the Preferred Trust Securities to investors, including F&C, by means of the false and misleading 2006 Offering Circular. ¶163. The Initial Purchaser Defendants collectively participated in the review and drafting of the Offering Circulars, approved the final Offering Circulars, solicited sales of the Offerings, and identified themselves as the initial purchasers for the Offerings. The Offering Circulars further identified Goldman Sachs as the Sole Structuring Coordinator and Bookrunner, *i.e.*, the leader of the

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

initial purchaser syndicate. ¶115. The Initial Purchasers purchased the Preferred Trust Securities from WaMu for resale to investors, including F&C. The Initial Purchasers entered into a "'firm commitment'" underwriting agreement with WaMu; the Initial Purchasers were obligated to purchase all of the Preferred Trust Securities if they purchased any of the Preferred Trust Securities. ¶116.

The 2006 Offering Circular, which incorporated by reference the false and misleading statements set forth in the Form 10-K for the year ended December 31, 2004, the press release issued on October 19, 2005, the Form 10-Q for the quarter ending September 30, 2005, and the press release issued on January 18, 2006, also contained additional misrepresentations. ¶¶164-175. For example, Defendants represented that the home equity loans ("HELs") "'owned by the Asset Trust were, in all material respects, originated in accordance with the underwriting guidelines of WMB as described in herein. The HELs have been underwritten by WMB using automated underwriting systems. WMB's underwriting guidelines generally are intended to evaluate the prospective borrower's credit standing and repayment ability and the value and adequacy of the mortgaged property as collateral.'" ¶168. Moreover, Defendants explained that "'In evaluating a prospective borrower's ability to repay a HEL, the loan underwriter considers the ratio of the borrower's total monthly debt (including non-housing expenses) to the borrower's gross income (referred to as the 'debt-to-income ratio' or 'back-end ratio.'" *Id.* In truth, according to former WaMu employees, by no later than 2005 WaMu had abandoned appropriate and customary underwriting standards in order to artificially inflate loan volume. ¶66. WaMu pressed sales agents to pump out loans while disregarding borrowers' incomes and assets, according to former employees. *Id*. By no later than Fall 2005, WaMu senior executives, including the Officer Defendants, actively discouraged WaMu's risk managers from performing their responsibilities, purposefully dissuading risk managers from raising meaningful issues or negative findings. ¶65.

The 2006 Offering Circular also falsely and misleadingly described WaMu's appraisal practices claiming that the adequacy of the property being pledged as collateral generally was determined by an appraisal made in accordance with pre-established appraisal guidelines. ¶170. In fact, WaMu pressured appraisers to provide inflated property values that made loans appear less risky,

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

enabling Wall Street to bundle them more easily for sale to investors. ¶66. By 2006, a stunning number of loans at Long Beach Mortgage, the Company's subprime mortgage lender, were quickly going into default. ¶¶77-78. Defaults in the first few months of a loan are at least a red flag for fraud. ¶¶77-78.

As a result of the Initial Purchasers' experience in the secondary mortgage market, including the 2005-2006 underwriting of over $10 billion in securities backed by subprime loans originated by WaMu's wholly owned subsidiary Long Beach Mortgage, WaMu's subprime origination unit, the Initial Purchaser Defendants either knew or were reckless in not knowing that the Offering Circular was false or misleading. ¶122. By 2006, a stunning number of loans at Long Beach Mortgage were quickly going into default. ¶¶77-78.

As underwriters of securities backed by billions of dollars of WaMu's loans, the Initial Purchaser Defendants had direct access to extensive, non-public data concerning the credit quality of Washington Mutual's loans. For example, the Initial Purchaser Defendants had access to all of the underlying loan documents and, as underwriters of the mortgage-backed securities ("MBS"), were obligated to review samplings of the underlying loan documents to ascertain whether the loans were underwritten in accordance with applicable underwriting standards. ¶123. And, the Initial Purchaser Defendants had access to quality control reports on statistical sampling tests (referenced in the Offering Circulars), performed by WaMu's credit risk oversight department. ¶124. Had the Initial Purchaser Defendants conducted a reasonable investigation, including even a cursory review of the loans originated by WaMu, the true, but undisclosed facts, would have been readily apparent to them. ¶119.

E. False and Misleading Assurances to Investors Prior to the 2007 Offering

On March 15, 2006, WaMu filed with the SEC its Form 10-K for the fourth quarter and fiscal year ended December 31, 2005, amended on August 9, 2006, signed by Defendants Killinger, Casey, Farrell, Frank, Leppert, Lillis, Matthews, Murphy, Osmer McQuade, Pugh, Reed, Smith, Stever, and Wood. ¶176. WaMu's 2005 Form 10-K falsely reassured investors of the Company's dedication to appropriate underwriting to safeguard against unwarranted loan losses in its subprime business: "'The

Company seeks to mitigate the credit risk in this portfolio by ensuring compliance with underwriting standards on loans originated to subprime borrowers and by re-underwriting all purchased subprime loans.'" *Id*. In fact, as set forth above, by no later than 2005 WaMu had all but abandoned prudent efforts to ensure compliance with its own underwriting standards.

Furthermore, by 2006 WaMu was engaged in a criminal conspiracy to inflate appraisals on loans originated by the Company. ¶¶79-90. The scheme to inflate appraisals was discovered by New York State's Attorney General, who unearthed numerous e-mails documenting WaMu's role in the conspiracy. ¶¶86-87. WaMu's manipulation of appraisal values was not limited to isolated instances but, rather, was a systemic fraud. ¶85. By fraudulently inflating appraisals, WaMu was able to originate loans that had artificially low loan-to-value ratios ("LTV"). Fraudulently increased appraisals led to decreased LTV ratios, which made the Company's loan portfolios look less risky. ¶88. Falsifying appraisals also allowed WaMu to do loans that should never have been approved and could not be sold in the secondary market with a proper appraisal. This increased WaMu's reported loan origination volumes and revenues, inflating WaMu's reported financial results. ¶89.

At the Company's annual Investor Day conference, held on September 6 and 7, 2006, WaMu's executives praised the Company's "'strong underwriting,'" "'conservative lending standards,'" "'rigorous credit standards,'" and "'disciplined credit culture.'" ¶178. Specifically, Defendant Cathcart noted: "'At origination, WaMu focuses on an effective underwriting process and borrower disclosures[.]'" Hence, "'[w]ith respect to the borrower, the portfolio quality is very sound.'" *Id*. Cathcart continued: "'Even after maximum negative amortization and with no home price appreciation, the portfolio should remain well secured and the borrower should have sufficient equity to refinance, should they choose to do so.'" Defendant Cathcart concluded that, for Option ARM borrowers, "'WaMu controls the underwriting, so we have the opportunity to evaluate the borrower at the time of origination. Overall, we are comfortable with this portfolio.'" *Id*.

During the Company's Investor Day, the Officer Defendants falsely claimed WaMu was prepared for a weak housing market. Killinger misleadingly stated: "'For WaMu, a slowdown in housing will no doubt lead to higher delinquencies and credit cost, and again, we factor that into our

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

planning. However, as I alluded to earlier, we began planning for this quite some time ago, took a number of defensive actions. And so, I believe that we are very well positioned, regardless of what happens in the housing market.'" ¶179.

Defendant Schneider misleadingly assured investors that the Company had "'reserved for [subprime losses] appropriately and we have also, in second quarter of '06, tightened up a number of our underwriting guidelines, and you can see that in our numbers.'" ¶180. Touting his experience through many housing cycles, Rotella stated the Officer Defendants "'[felt] good about the fact that we've been aggressive in controlling what we can control. Frankly, we've been ahead of the market in my perspective.'" Defendant Cathcart misleadingly asserted "'we have been watching our credit profile diligently for the last two years, and we've been making strategic choices to prepare for the environment we currently find ourselves in.'" ¶181.

These statements were materially false and misleading because WaMu (i) artificially inflated loan volume by secretly abandoning prudent underwriting standards; (ii) disregarded the warnings of its risk managers and otherwise minimized the role of risk management so as to pursue its undisclosed risky business practices; (iii) artificially inflated appraisal values to close loans that otherwise would not have been done; and (iv) misstated its financial results by not properly provisioning for loan losses that were highly likely to result from the Company's disregard for proper underwriting and fraudulent appraisal manipulations. ¶183. Contrary to WaMu's Form 10-K, WaMu did not ensure compliance with underwriting standards on loans originated to subprime borrowers. *Id*. Contrary to statements made at the investor conference, WaMu's loan quality was not "'very sound'" but rather very risky and the Company had not been making "'strategic choices to prepare for'" a downturn in the housing market. *Id*. Contrary to Defendant Schneider's statements, WaMu was not appropriately reserved for subprime losses and had not meaningfully tightened its underwriting guidelines as the Company continued to issue significant loans in violation of its stated underwriting guidelines. *Id*.

On March 1, 2007, WaMu filed with the SEC its Form 10-K for the fourth quarter and fiscal year ended December 31, 2006, which was expressly incorporated by reference in the 2007 Offering Circular. ¶184. Defendants Killinger, Casey, Farrell, Frank, Leppert, Lillis, Matthews, Murphy,

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

Osmer McQuade, Montoya, Pugh, Reed, Smith, and Stever signed the 2006 Form 10-K. Defendants Killinger and Casey signed certifications attesting to the accuracy of the information contained in the 2006 Form 10-K and the adequacy of the Company's internal controls, substantially similar to the statements in ¶¶151-52. The 2006 Form 10-K reported WaMu's false and misleading 2006 financial results which were not prepared in accordance with GAAP. ¶184.

In the 2006 Form 10-K, the Company continued to misleadingly emphasize its underwriting and other procedures as a safeguard against incurring unwarranted credit risk. ¶186. For example, WaMu stated in the 2006 Form 10-K: "'The Company actively manages the credit risk inherent in its Option ARM portfolio primarily by ensuring compliance with its underwriting standards, monitoring loan performance and conducting risk modeling procedures.'" *Id.* Likewise, the 2006 Form 10-K emphasized the Company's underwriting practices for its subprime mortgages, reassuring investors that "'loan application and appraisal packages are reviewed to ensure conformity with the Company's stated credit guidelines. … Similarly, all purchases from Subprime Lenders must satisfy the Company's stated credit guidelines.'" ¶186. In fact, as set forth above, WaMu had abandoned underwriting efforts and did not ensure its subprime loan portfolio consisted of loans originated in conformity with the Company's stated credit guidelines. Moreover, by February 2007, WaMu was engaged in a criminal conspiracy to manipulate the appraised values of homes acting as collateral for WaMu-originated loans. ¶¶79-90.

Despite the fact that on April 17, 2007, eAppraiseIT's President wrote a memorandum to WaMu that WaMu's selection of appraisers "'appears to be directly in contradiction to the interagency guidelines'" promulgated by the Office of Thrift Supervision, Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation ("FDIC") (¶87) that same day the Company conducted a conference call with investors and Defendant Killinger stated that the Company was "'seeing encouraging signs with the improvement in the prime business that we saw in the first quarter, and with the steps that we've taken into the subprime area of increasing pricing, improving underwriting, that we are starting to see that show up in the way of early signs of credit on the 2007 production looks much better than '06, so that's encouraging.'" ¶190. Defendant Casey echoed these

false statements by asserting that "'we have significantly increased our pricing and decreased our risk profile that we're willing to underwrite to, and so we think all those factors taken together will make this business a little more profitable. We are being selective with our underwriting.'" *Id*. Additionally, Defendant Rotella stated, "'we have absolutely no plans to shut down our subprime channel. We have, as you've heard, since the beginning of last year been tightening credit in that part of our business.'" *Id*.

On July 18, 2007, WaMu issued a press release announcing its financial results for the quarter ended June 30, 2007. ¶195. This press release was expressly incorporated by reference into the 2007 Offering Circular. *Id*. That same day, the Company held a conference call with investors to discuss the results. During the call, the Officer Defendants again sought to reassure investors that WaMu was prudent and conservative in its business practices. ¶196. For instance, Defendant Killinger stated that WaMu was "'tightening underwriting'" and helping "'lead the industry to what we think is much more prudent and appropriate underwriting standards at this point in the cycle.'" *Id*. Further, Defendant Casey stated, "'While we anticipate that we will see higher [nonperforming assets] across all of our home loan portfolios, we expect losses in the prime loans to be much lower due to the lower LTVs and high FICO profile of our prime portfolio.'" *Id*.

On October 17, 2007, WaMu issued a press release announcing its financial results for the quarter ended September 30, 2007. ¶202. This press release was expressly incorporated by reference into the 2007 Offering Circular. *Id*. In this press release, WaMu announced "'third quarter 2007 net income of $210 million, or $0.23 per diluted share, compared with net income of $748 million, or $0.77 per diluted share, in the third quarter of 2006. The company attributed the decline to a weaker housing market and disruptions in the capital markets.'" *Id*. Defendant Killinger misleadingly attributed the Company's lower results to "'the increasingly difficult market conditions that are challenging the banking industry'" without reference to the Company's prior disregard for proper underwriting and appraisal standards. *Id*.

WaMu's earnings as reported in the October 17, 2007 press release were false and misleading and not in compliance with GAAP. ¶203. WaMu substantially and materially understated the amount

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

of the provision that WaMu was required to record under GAAP to properly reserve for its impending loan losses. *Id*. WaMu's Provision and Allowance for Loan and Lease Losses was based on fraudulently manipulated appraisals and therefore did not take into account the true value of the underlying collateral. Moreover, WaMu's allowance was far too inadequate in light of the true credit profile of its borrowers, many of whom only obtained loans from WaMu because the Company abandoned appropriate underwriting standards. *Id*.

The inadequacy of the Company's allowance began to be revealed when, on November 1, 2007, the New York Attorney General revealed WaMu had falsified appraisals and then again, on December 10, 2007, when WaMu was forced to announce it was increasing its allowance provision for the fourth quarter by approximately $400 million and expected to take additional substantial increases throughout 2008. *Id*.

F. The False and Misleading 2007 Offering Documents

Goldman Sachs, Credit Suisse, and Morgan Stanley, along with now-bankrupt Lehman Brothers Inc., sold $1 billion of the 2007 Preferred Trust Securities to investors, including F&C, by means of a false and misleading offering circular, dated October 18, 2007 ("2007 Offering Circular"). ¶204. The 2007 Offering Circular incorporated by reference the false and misleading statements set forth in the Form 10-K for the year ending December 31, 2006, the Form 10-Q for the quarter ending March 31, 2007, the July 18, 2007 press release, and the Form 10-Q for the quarter ending June 30, 2007. ¶205. The 2007 Offering Circular falsely and misleadingly described WaMu's underwriting practices:

> WMB's underwriting guidelines generally are intended to evaluate the prospective borrower's credit standing and repayment ability and the value and adequacy of the mortgaged property as collateral. … Prospective borrowers are required to provide details about their financial factors such as their assets, liabilities and related monthly expenses, as well as income and employment information.
>
> ¶209.

In fact, according to former WaMu employees, no later than 2005, WaMu had abandoned appropriate and customary underwriting standards in order to artificially inflate loan volume by disregarding borrowers' incomes and assets. ¶66.

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

The 2007 Offering Circular also falsely and misleadingly described WaMu's appraisal practices stating that the adequacy of the property being pledged as collateral generally was determined by an appraisal made in accordance with pre-established appraisal guidelines. ¶211. In fact, WaMu was engaged in a criminal conspiracy to manipulate appraisals in contravention of appraisal guidelines and federal regulations. ¶¶79-90.

Despite the fact that by no later than Fall 2005, WaMu senior executives, including the Officer Defendants, actively discouraged WaMu's risk managers from performing their responsibilities, purposefully dissuading risk managers from raising meaningful issues or negative findings (¶65), the 2007 Offering Circular falsely and misleadingly assured investors that WaMu maintained appropriate credit risk management procedures and policies to monitor the Company's lending practices and loan portfolio and safeguard the Company from incurring unreasonably risky loans from borrowers who could not afford to repay. ¶215. The 2007 Offering Circular misleadingly stated that:

> The Chief Credit Officer is responsible for overseeing the work of a credit policy committee, monitoring the quality of the WMI Group's credit portfolio, determining the reasonableness of the WMI Group's allowance for loan losses, reviewing and approving large credit exposures and setting underwriting criteria for credit-related products and programs. Credit risk management is based on analyzing creditworthiness of the borrower, the adequacy of the underlying collateral given current events and conditions and the existence and strength of any guarantor support.
>
> ¶215.

In truth, in the Fall of 2005 and throughout the relevant period prior to the Offerings, WaMu's chief compliance and risk-oversight officer made it clear that "'[t]hey weren't going to have risk management get in the way of what they wanted to do, which was basically lend the customers more money,'" according to Dale George, a senior credit-risk officer. ¶64.

The Initial Purchaser Defendants were negligent in not discovering the truth concerning WaMu's true financial condition and the credit quality of its loan portfolio. ¶119. In particular, Goldman Sachs knew or should have known that, among other things, that WaMu's mortgage loans were being carried on WaMu's balance sheet at exceedingly high valuations with improper Allowances for Loan Losses as a result of the significant risk the loans would not be repaid. ¶126. Prior to the 2007

Offering, Goldman Sachs believed WaMu's entire business model was imperiled. At the same time Goldman Sachs was selling the 2007 Preferred Trust Securities to Plaintiffs – the valuation of which was dependent upon, among other things, Washington Mutual's subprime mortgage loan portfolios and subprime lending business – Goldman Sachs was making billions of dollars by betting against the subprime mortgage market. ¶130. In August through October 2007, Goldman Sachs wrote down the valuations of MBSs linked to trades (credit default swaps) with insurer AIG. In writing down the valuations on the securities linked to the credit default swaps, Goldman Sachs sought collateral calls from AIG of $1.5 billion in August 2007 and $3 billion in October 2007. ¶136.

Thus, at the same time Goldman Sachs was selling to Plaintiffs the 2007 Preferred Trust Securities – the value of which was dependent upon, among other things, the inflated valuations of residential subprime mortgage loans on WaMu's balance sheet– Goldman Sachs was secretly insisting for its own purposes that securities backed by residential subprime mortgage loans were significantly impaired and their valuations had to be written down. ¶137. Goldman Sachs' bet against WaMu's business model, and the creditworthiness of the assets underlying WaMu's balance sheet, was made by the most senior executives of Goldman Sachs. ¶¶133, 135. Despite Goldman Sachs' access to material, non-public information concerning the loans made by WaMu and other mortgage lenders, and Goldman Sachs' strong convictions to bet billions of dollars against the valuations of subprime mortgage securities like those on WaMu's books, Goldman Sachs never conducted a reasonable investigation to correct the false statements in the Offering Circulars provided to F&C.

G. WaMu Collapses and the Truth Is Revealed

Washington Mutual's true financial condition and business practices began to come to light only days after Defendants completed the 2007 Offering on or about October 25, 2007. On November 1, New York Attorney General Andrew Cuomo revealed Washington Mutual orchestrated a systemic fraud to illegally inflate appraisals used in its loan origination process. ¶12. By December 2007, the SEC launched an inquiry into Washington Mutual's public disclosures concerning its lending practices and its accounting for loans. The SEC investigation was followed up by a criminal investigation, in which a grand jury has been convened. ¶13.

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

On December 10, 2007, after the close of the market, WaMu announced alarming changes to its business model and previous practices, which were the foreseeable result of the Company's unsustainable and undisclosed risky lending practices, appraisal fraud and GAAP violations. ¶223. WaMu was cutting its quarterly dividend from $0.56 per share to $0.15 per share. WaMu further increased its loan loss provision guidance for the fourth quarter 2007 to $1.5 to $1.6 billion, from $1.1 to $1.3 billion, and announced additional substantial increases would result throughout 2008. *Id*. WaMu also announced it would end its subprime lending business, significantly pull back on its other residential lending business, and incur a $1.6 billion after-tax charge against goodwill associated with its home loans business. *Id*.

As a result of WaMu's disclosures on December 10, 2007, Moody's cut WaMu's credit rating two notches to Baa2 from A3, noting the move was based on "'its view that credit losses from WaMu's mortgage operations will be noticeably higher than previously estimated.'"¶224. That same day, Fitch Ratings downgraded WaMu to A- from A citing "'worsening asset quality metrics.'" *Id*.

On December 20, 2007, after the market closed, The Wall Street Journal reported that the SEC had launched an inquiry into WaMu's public disclosures of its mortgage lending practices and accounting. ¶225. According to The Wall Street Journal, the SEC was investigating whether "'the company properly accounted for its loans in financial disclosures to investors of the company.'" WaMu confirmed the SEC's inquiry. *Id*.

On March 3, 2008, Fitch Ratings downgraded $2.3 billion worth of WaMu subprime mortgage-backed securities. Fitch based its downgrade on "'the deteriorating performance of [WaMu's mortgage] pools from 2007, 2006 and late 2005 with regard to continued poor loan performance and home price weakness.'" ¶227. And on March 7, 2008, Fitch Ratings lowered its ratings on WaMu because of the "'rapid deterioration'" in WaMu's home equity loans portfolio. ¶229.

On March 27, 2008, Lehman Brothers issued an analyst report estimating WaMu would need to take loan loss provisions of $10 billion in 2008 and an additional $5 billion in 2009. Further, according to Lehman Brothers' analyst, WaMu would report an earnings loss of $2.84 per share for 2008. WaMu,

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

Lehman Brothers' analyst estimated, would incur $6 billion in charge-offs in 2008 and $7 billion in charge-offs in 2009. ¶231.

On April 8, 2008, WaMu announced a net loss of $1.1 billion, or $1.40 per share, for the first quarter of 2008. The Company recorded a loan loss provision of $3.5 billion. ¶232.

On April 11, 2008, Goldman Sachs issued an analyst report, recommending that its clients short sell WaMu stock. Goldman Sachs wrote: "'The bad news is that our new product-by-product analysis of its mortgage portfolio suggests $17 billion to $23 billion of embedded losses in WaMu's current book of business, of which only $3 billion have been absorbed so far; subsequently, we forecast a $14bn provision charge in 2008.'" ¶233. Goldman Sachs further estimated that WaMu may lose $3.30 per share in 2008. Goldman Sachs' recommendation to "'short'" WaMu was a significant revelation to investors. *Id*.

On July 22, 2008, WaMu announced its second quarter 2008 financial results, including that the Company suffered a net loss of $3.3 billion as a result of a significant increase in its loan loss reserves. This was a loss of $3.34 per share (excluding a one-time earnings reduction customarily made by analysts in assessing GAAP earnings). WaMu had to take a $5.9 billion loan loss provision in the quarter and had to increase its loan loss reserves by $3.74 billion to $8.46 billion. WaMu now anticipated cumulative losses in its residential mortgage portfolio to total $19 billion. ¶235.

Throughout September 2008, WaMu's financial condition worsened and the rating agencies downgraded their estimation of its creditworthiness. On September 25, 2008, the FDIC took control of WaMu and dismissed its senior management. ¶237. WaMu was insolvent. The Company's securities, already significantly depressed, were rendered essentially worthless. Massive lending losses, exacerbated by insufficient reserves, caused WaMu's collapse, the biggest bank failure in U.S. history. WaMu's collapse was the foreseeable result of WaMu's undisclosed reckless lending practices and improper accounting. ¶237.

Upon seizing WaMu, the FDIC immediately sold off WaMu's assets and bank deposits to the highest bidder which revealed WaMu had significantly inflated the valuations of the residential mortgage loans on its balance sheet and had engaged in excessively risky lending practices. ¶238.

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

On September 26, 2008, as a result of the FDIC's takeover of Washington Mutual Bank and the bankruptcy of Washington Mutual, Inc., Plaintiffs' investments in the Preferred Trust Securities automatically converted into preferred stock of Washington Mutual, Inc., and thereby rendered worthless. ¶16.

IV. LEGAL STANDARDS

As this Court previously held in the related securities class action, "[o]n a 12(b)(6) motion to dismiss, the Court must assess the legal feasibility of the Complaint. Accordingly, the Court accepts Plaintiffs' factual allegations as true and draws all reasonable inferences in Plaintiffs' favor. Dismissal is appropriate only where a complaint fails to allege 'enough facts to state a claim to relief that is plausible on its face.'" *WaMu I*, 259 F.R.D. at 494-95 (quoting *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007)).

Under the notice pleading standards of Rule 8(a) of the Federal Rules of Civil Procedure, a complaint must allege "enough facts to state a claim to relief that is plausible on its face." *Bell Atlantic*, 550 U.S. at 570.[5] When claims of fraud are alleged, Rule 9(b) requires that "the circumstances constituting fraud or mistake … be stated with particularity." Fed. R. Civ. P. 9(b). In meeting the requirements of Rule 9(b), a complaint must contain "particularized allegations of the circumstances constituting fraud," which may include the "time, place, and content of an alleged misrepresentation" in addition to the "circumstances indicating falseness." *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1547-48 (9th Cir. 1994).

F&C alleges negligence-based causes of action against all Defendants, as well as fraud claims against the Officer Defendants. All claims against the Officer Defendants "necessarily allege fraudulent conduct and are subject to the heightened pleading requirement of Rule 9(b). However, because it is

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[5] Subsequent to the Court's initial motion to dismiss ruling on the class action the Supreme Court decided *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009), which discusses the application of Rule 8(a)(2). However, as the Court noted in it's second motion to dismiss decision, "*Iqbal* reaffirms the Supreme Court's decision in *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 127 S. Ct. 1955, 167 L. Ed. 2d 929 (2007) and does not alter the standard the Court previously employed to test those claims in the Complaint subject to Rule 8." *WaMu II*, 2009 U.S. Dist. LEXIS 99727, at *7-*8.

possible for a defendant to participate in the dissemination of fraudulent statements without awareness of the actual fraud, Rule 9(b) applies only to those defendants also accused in the underlying fraud." *WaMu I*, 259 F.R.D. at 504 (citing *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 1163 (C.D. Cal. 2008). Accordingly, the negligence-based claims asserted against the Director and Initial Purchaser Defendants are not subject to Rule 9(b) scrutiny, and must only meet the notice pleading requirements of Rule 8(a).

V. ARGUMENT

A. F&C Pleads Violations of the Federal Securities Laws

Congress made it clear that"[t]he overriding purpose of our Nation's securities laws is to protect investors and to maintain confidence in the securities markets, so that our national savings, capital formation and investment may grow for the benefit of all Americans.… ***Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action***." H.R. Conf. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 730.

F&C alleges violations of the federal securities laws against the Individual Defendants. In particular, the Amended Complaint alleges violations of §10(b) of the Securities Exchange Act of 1934 against the Officer Defendants, as well as violations of §§20(a) and 18 of the Exchange Act against both the Officer and Director Defendants.

1. The Officer Defendants Violated §10(b); F&C Relied Upon the Officer Defendants' False and Misleading Statements

A complaint states a claim under §10(b) when it alleges "(1) a strong inference of scienter, (2) a material misrepresentation or omission, (3) a connection with the purchase or sale of a security, (4) reliance, (5) economic loss, and (6) loss causation." *WaMu II*, 2009 U.S. Dist. LEXIS 99727, at *15 (citing *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005)). The Court previously denied the Officer Defendants' motions to dismiss §10(b) claims, holding that plaintiffs in the class action sufficiently alleged false statements made with scienter regarding WaMu's "risk management,

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

appraisals, underwriting, financial statements, and internal controls." *WaMu II*, 2009 U.S. Dist. LEXIS 99727, at *71.

The §10(b) claims asserted by F&C against the Officer Defendants are based upon the same categories of false and misleading statements, and in many instances on the exact statements, upheld in the class action.[6] Moreover, F&C alleges actual reliance on the false and misleading statements.[7] *See* ¶24. This clearly satisfies the elements of a valid §10(b) claim.

Nonetheless, the Officer Defendants assert that F&C does not adequately plead actual reliance because it fails to allege "facts showing that [F&C]relied on any of the alleged misstatements." WaMu Officers' Motion to Dismiss Amended Complaint ("OD Mem.") at 5.[8] This argument is contrary to F&C's allegations and the law. F&C – "sophisticated" institutional investors, as Defendants have labeled them – actually "read and relied upon the Offering Circulars and the documents incorporated by reference, as well as analyst reports and credit ratings agency reports concerning Washington Mutual that repeated and/or relied upon Defendants' false and misleading statements." ¶24. The Officer Defendants simply ignore these allegations.

Where, as here, a plaintiff alleges "that the statements were read and relied upon in connection with the purchase of … securities," the actual reliance requirement is satisfied. *In re Able Labs. Sec. Litig.*, No. 05-2681 (JAG), 2008 U.S. Dist. LEXIS 23538, at *96 (D.N.J. Mar. 24, 2008). Indeed, the

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[6] The Court need not revisit its prior rulings, including its decision to uphold the §10(b) claims alleged in the class action, where here F&C alleges "facts [that] echo the class action lawsuit." *In re Tyco Int'l, Ltd. Multidistrict Litig.*, No. 02-1335-B, 2007 U.S. Dist. LEXIS 42401, at *9 (D.N.H. June 11, 2007); *see also S. Or. Barter Fair v. Jackson County*, 372 F.3d 1128, 1136 (9th Cir. 2004) (the law of the case doctrine "precludes a court from reexamining an issue previously decided by the same court or a higher court in the same case").

[7] In pleading actual reliance, F&C also meets the reliance element required for its claims asserted under §18 of the Exchange Act. *See* 15 U.S.C. §78r(a).

[8] The Officer Defendants' reliance upon *Desai v. Deutsche Bank Sec. Ltd.*, 573 F.3d 931, 939 (9th Cir. 2009) is inapposite. OD Mem. at 5. In *Desai*, the Ninth Circuit did not rule upon the issue of actual reliance, which is alleged here, but rather opined on the issue of presumption of reliance in §10(b) class actions – "[p]recisely to which cases this presumption applies – that is, to misrepresentation, to omission, to manipulation cases, or to some combination of the three – is an issue the parties contest on appeal." 573 F.3d 931 at 939.

Court previously held (in connection with the reliance element under §11 of the Securities Act of 1933) allegations that a plaintiff acquired securities "'relying upon the statements … shown above to be untrue and/or relying upon the Registration Statements … [were] sufficient under Rule 9 to allege reliance. …" *WaMu II*, 2009 U.S. Dist. LEXIS 99727, at *56. F&C has more than adequately alleged actual reliance.

2. The Individual Defendants' §20(a) Argument Is Moot

A complaint sufficiently states a claim for control person liability under§20(a) of the Exchange Act if it alleges: (1) a primary violation of the securities laws; and (2) that a defendant possessed power or control that directly or indirectly induced a violation of the securities laws. *See No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West*, 320 F.3d 920, 945 (9th Cir. 2003).

The Amended Complaint satisfies the first element required of §20(a) by pleading a primary violation of the federal securities laws. *See supra,* §V.A.1. Accordingly, because the Individual Defendants only challenged F&C's §20(a) claim with respect to the first element, their motions to dismiss this cause of action should be denied.[9]

3. F&C's §18 Claims Are Not Time-Barred

To plead a §18 claim, a plaintiff must allege: (1) a false or misleading statement or omission; (2) that is material; (3) that is contained in an SEC filing (pursuant to the Exchange Act); and (4) upon which the plaintiff relied in its purchase of securities. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 211 n.31 (1976). F&C alleges each of these elements, and the Individual Defendants concede as much.

Despite this, the Individual Defendants assert that F&C's §18 claim is timebarred as a matter of law by the statute of limitations. OD Mem. at 11-13; Outside Directors' Motion to Dismiss Amended

[9] As to the second element, the SEC has defined "control" to include "thepossession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. §230.405. The Complaint adequately alleges facts demonstrating that the Individual Defendants were controlling persons vested with the "power to direct" the "management and policies" of WaMu within the meaning of §20(a), which "'was enacted to expand rather than restrict the scope of liability under the securities laws.'" *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1572 n.17, 1577 (9th Cir. 1990).

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

Complaint ("DD Mem.") at 16. The Individual Defendants misstate the law with respect to the correct limitations period applicable to §18 claims.

While the language of §18 states that an action must be brought "within one year after the discovery of the facts constituting the cause of action," 15 U.S.C. §78r(c), under the Sarbanes-Oxley Act of 2002 ("SOX"), Congress extended the statute of limitations to "2 years after discovery of the facts constituting the violation" for any "private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning securities laws." 28 U.S.C. §1658(b).

As the Supreme Court has explained, §18 "'target[s] the precise dangers that are the focus of §10(b)' and ***the intent . . . is the same − 'to deter fraud and manipulative practices in the securities markets, and to ensure full disclosure of information material to investment decisions***.'" *Musick, Peeler & Garrett v. Employers Ins.*, 508 U.S. 286, 295-96 (1993). "[I]n fact the same material misstatement or omission can be the basis for both claims. Moreover, the only difference between pleading claims under §18 of the Exchange Act and §10(b) of the Exchange Act is that §18 requires that a plaintiff sufficiently pleads reliance but not scienter, while §10(b) requires that a plaintiff sufficiently pleads scienter but not reliance." *Able Labs.*, 2008 U.S. Dist. LEXIS 23538, at *89. Indeed, as noted by the Second Circuit almost 30 years ago, "[b]y its terms, §10(b) prohibits a ***broader*** range of conduct than does §18." *Ross v. A. H. Robins Co.*, 607 F.2d 545, 552 (2d Cir. 1979).

Furthermore, since its passage, Courts have expressly found Sarbanes-Oxley's extended limitations periods apply to §18 claims. *See Teachers' Sys. of La. v. Qwest Commc'ns. Int'l Inc.*, No. 04-0782-REB-CBS, 2005 U.S. Dist. LEXIS 44756, at *7-*8 (D. Colo. Sept. 23, 2005) (holding that §18 "easily" fell within the parameters of a claim involving "fraud, deceit, manipulation, or contrivance" to which the Sarbanes-Oxley Act's extended limitations periods apply); *In re Adelphia Commc'ns Corp. Sec. & Derivative Litig.*, No. 03 MD 1529 (LMM), 2005 U.S. Dist. LEXIS 14444, at *20 (S.D.N.Y. July 18, 2005) (holding that §18 claims involve "'fraud, deceit, manipulation, or contrivance'" for purposes of the Sarbanes-Oxley limitations periods); and *In re Stone & Webster, Inc. Sec. Litig.*, No. 00-10874-RWZ, 2006 U.S. Dist. LEXIS 42061 (D. Mass. June 23, 2006) (same). Thus,

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

F&C's §18 claim is premised on allegations of fraud, deceit, and contrivance in contravention of regulatory requirements concerning the securities laws, and is subject to the extended two-year limitations period under the SOX.[10]

Applying the two-year statute of limitations under SOX, F&C's §18 claim is unquestionably timely because the initial complaint was filed on October 16, 2009, less than two years after the Individual Defendants contend that F&C had notice of the claim based upon the commencement of the New York Attorney General's action on November 1, 2007. *See* OD Mem. at 11.

B. F&C Properly Pleads Violations of California's Corporate Securities Law

"California's policy is to protect the public from fraud and deception in securities transactions. The Corporate Securities Law of 1968 was enacted to effectuate this policy by regulating securities

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[10] F&C is aware of the Court's unpublished decision in *Reese v. Malone*, No. C08-1008 MJP, 2009 U.S. Dist. LEXIS 15774 (W.D. Wash. Feb. 27, 2009), holding that "the extended limitations period applies only to causes of action concerning fraud … [and] nothing in the language or history of Sarbanes-Oxley indicates a clear intent to overrule express limitations period." *Id*. at *25-*26. F&C respectfully asserts the current argument to preserve its rights on appeal, as the Ninth Circuit has yet to rule on this issue. However, a review of the legislative history, and particularly the Conference Report, confirms that Congress intended SOX to be applied to all private securities causes of action under the Securities Exchange Act of 1934. Title VIII, which is the section at issue, was authored by Senator Patrick Leahy who stated that it would apply to "all … existing private causes of action under the various federal securities laws." 148 Cong. Rec. S.7418 (daily ed. July 26, 2002). Senator Leahy provided a section-by-section analysis of Title VIII Congressional Record, as part of the official legislative history:

> Section 804. – Statute of Limitations
>
> This provision states that it is not meant to create any new private cause of action, but only ***to govern all the already existing private causes of action under the various federal securities laws that have been held to support private causes of action. This provision is intended to lengthen any statute of limitations under federal securities law, and to shorten none***. The section, by its plain terms, applies to any and all cases filed after the effective date of the Act, regardless of when the underlying conduct occurred.

148 Cong. Rec. S.7418. Senator Leahy's analysis demonstrates that Congress intended for the extended statute of limitations to apply to all federal securities laws, including §18. Indeed, the preamble states that the law was passed "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes." Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745. Accordingly, SOX did not seek only to protect againstfraud, and §804 should not be read as such.

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

transactions in California and providing statutory remedies for violations of the Corporations Code, in addition to those available under common law." *Hall v. The Superior Court of Orange County*, 150 Cal. App. 3d 411, 417 (1983).

1. Goldman Sachs Violated California Corporations Code §§25401/25501

California Corporations Code §25401 provides that: "It is unlawful for any person to offer or sell a security in [California] or buy or offer to buy a security in [California] by means of any written or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." Among other things, §25501 provides purchasers with a private right of action. "Sections 25401 and 25501 differ from common law negligent misrepresentation in that: (1) proof of reliance is not required, (2) although the fact misrepresented or omitted must be 'material,' no proof of causation is required, and (3) plaintiff need not plead defendant's negligence." *Bowden v. Robinson*, 67 Cal. App. 3d 705, 715-16 (1977).

F&C makes out a *prima facie* case against Goldman Sachs pursuant to §§25401/25501. ***Goldman Sachs does not dispute that it sold the Preferred Trust Securities to Flaherty & Crumrine pursuant to the Offering Circulars containing false and misleading statements*** Indeed, the Court has already held that similar allegations in the WaMu securities class action sufficiently plead that identical (and substantially similar) statements made by Defendants were false and misleading at the time they were made. *See supra*, §II.

As §§25401/25501 do not require proof of reliance or loss causation, and the plaintiff need not plead negligence, *Bowden*, 67 Cal. App. 3d at 715-16[11], Goldman Sachs' arguments concerning

[11] *See also* Harold Marsh, Jr. & Robert H. Volk, *Practice Under the California Securities Laws* §14.03[3][a] (2009) ("Neither Corp. Code §25401 nor Corp. Code §25501 requires that the plaintiff allege or prove as part of his or her *prima facie* case that the misstatement or omission by the defendant was made intentionally or negligently."); *Id.* at §14.03[6] ("Corp. Code §§25401 and 25501 do not require that the plaintiff establish that he or she relied on the false or misleading statement of the defendant in purchase or selling the securities."); *Id.* at §14.03[7] ("Corp. Code §§25401 and 25501 do

reliance (Motion to Dismiss Amended Complaint by Defendants Goldman, Sachs & Co., Credit Suisse Securities (USA) LLC, and Morgan Stanley & Co. Incorporated ("IP Mem.") at 16-17), loss causation (*id.* at 23-24) and negligence (*id.* 8-16, 19-20) are irrelevant to this cause of action.

F&C pleads all of the requisite elements to state a claim against Goldman Sachs for violating §§25401/25501, and the Amended Complaint provides Goldman Sachs with ample notice of the nature of F&C's claims. Sections 25401/25501 claims are based in negligence, not fraud, and therefore need not comply with Rule 9(b). *Openwave Sys. v. Fuld*, No. C08-5683 SI, 2009 U.S. Dist. LEXIS 48206, at *12 (N.D. Cal. June 6, 2009) ("the Court agrees with plaintiff that the first cause of action [under §25401] need ***not*** comply with Rule 9(b)"). As this Court has already held, Rule 9(b) does not apply to claims grounded in negligence that do not sound in fraud. *See supra*, §IV. F&C's allegations against Goldman Sachs do not sound in fraud. ¶¶5, 50. Even though Rule 9(b) is inapplicable to the §§25401/25501 claims, F&C satisfies Rule 9(b) by pleading the "'the time, place, and content of [each] alleged misrepresentation' in addition to 'the circumstances indicating falseness.'" *WaMu I*, 259 F.R.D. at 503. *See* ¶¶143-219.

a) Goldman Offered the Preferred Shares to Flaherty & Crumrine in California; F&C May Avail Itself of California's Investor Protection Statutes

"Typically, a defrauded buyer of a security may assert a blue sky claim under thelaw of his own state." *In re Nat'l Century Fin. Enters.*, 541 F. Supp. 2d 986, 1008 (S.D. Ohio 2007). All of the Plaintiffs purchased through Flaherty & Crumrine Inc.'s California headquarters. ¶24. F&C pleads a sufficient nexus to California for application of the Corporations Code.

Sections 25401/25501 apply to securities ***offered or sold*** in California. Flaherty & Crumrine purchased the Preferred Trust Securities in California. ¶24. Accordingly, F&C is entitled to the protections of §§25401/25501.

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not require that the plaintiff demonstrate any connection between the false or misleading statementand the damages suffered by the plaintiff.").

Contrary to the well-pleaded allegations, Goldman Sachs incorrectly argues that F&C purchased the Preferred Trust Securities in New York because the Offering Circulars state "both payment and delivery of the securities would be ***completed*** in New York." I.P. Mem. at 19. Whether the transaction was ultimately completed in New York, however, is irrelevant. Flaherty & Crumrine authorized the purchase and paid for the Preferred Trust Securities from its headquarters in California. The Ninth Circuit has held: "As the purpose of the California Securities Laws is to protect investor-residents, we consider that the payment by [the investor] in the form of a check mailed from California, constituted a sale of securities in California. …" *Parvin v. Davis Oil Co.*, 524 F.2d 112, 117 (9th Cir. 1975) (also holding with regards to a different transaction, "sending of the agreement to [the investor] and his subsequent signing of it in California constitute a sale of securities in California").[12] Sections 25401/25501 are applicable to F&C's purchase of the Preferred Trust Securities.

In the alternative, Flaherty & Crumrine may bring claims pursuant to §§25401/25501 not only because F&C purchased the Preferred Trust Securities in California, but also because Goldman Sachs offered the Preferred Trust Securities in California.

"Corp. Code §25008 provides that California jurisdiction will attach if any one of the three following elements takes place in the State of California: (1) the offer to sell is made in this state; (2) an offer to buy is accepted in this state; or (3) the security is delivered to the purchaser in this state if both the seller and the purchaser are domiciled in this state." Marsh & Volk, *supra* §3.08[1]. Simply put, as is the case here, §§25401/25501 apply to "***[o]ffers made from outside the state to persons in the state.***" *Id.* *See also* Keith Paul Bishop, *California's Blue Sky Law Problems for Foreign Issues and Foreign Issuers*, *Insights*, July 2009 (Thorpe Decl., Ex. A), at 31 ("offers directed from outside the state to persons in California will be subject to the CSL").[13]

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[12] *See also In re Victor Techs. Sec. Litig.*, 102 F.R.D. 53, 60 (N.D. Cal. 1984, *aff'd*, 792 F.2d 862 (9th Cir. 1986)) (refusing to certify a nationwide class but holding: "Of course, … California purchasers … will be entitled to maintain a claim under the California Code [Sections 25500 and 25501]".)

[13] All references to the "Thorpe Decl." refer to the Declaration of David A. Thorpe in Further Support of Flaherty & Crumrine Plaintiffs' Consolidated Opposition to Defendants' Motions to Dismiss the Amended Complaint, filed concurrently herewith.

Sections 25401/25501 apply here as Goldman Sachs directed an offer from outside California to Flaherty & Crumrine in California. Goldman Sachs' communications were directed to F&C through Flaherty & Crumrine, Inc.'s headquarters and principal place of business in Pasadena, California. ¶24. Goldman Sachs made false and misleading statements concerning the Preferred Trust Securities to F&C (through F&C's California office), upon which Plaintiffs (through F&C's California office) relied when purchasing the Preferred Trust Securities. ¶¶4, 20, 22, 24, 115, 282.

Goldman Sachs concedes that F&C properly pleads "that the offering circulars were … directed to Plaintiffs in California" but, according to Goldman, F&C fails to plead that the Offering Circulars were ever "received by Plaintiffs in California." IP Mem. at 18. Goldman Sachs is being far too literal, and quite misleading. The Amended Complaint clearly alleges Goldman Sachs sent F&C the Offering Circulars in California, and that F&C read and relied upon the Offering Circulars in California. This is more than sufficient under §25008.[14]

Goldman Sachs asserts that the California's Corporations Code does not apply because the Offering Circulars "state that both payment and delivery of the ***securities*** would be completed in New York." IP Mem. at 18. This is a "red herring." Where the ***securities*** were delivered is irrelevant. Where the transaction closed is irrelevant. The Corporations Code and case law make it clear that "parties may believe that they can avoid California's jurisdiction by moving the closing out of state. ***This will not work***, however, if the parties already have had communications in California that constitute an offer." Thorpe Decl., Ex. A at 31. As one noted treatise deals with Goldman Sachs' argument:

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[14] Goldman Sachs' authorities are inapposite. In *Hudson v. Sherwood Sec. Corp*., No. C-86-20344-WAI, 1987 U.S. Dist. LEXIS 16019, at *16-*18 (N.D. Cal. Nov. 5, 1987), as Goldman Sachs recognizes, "the securities were offered and sold in New York" (IP mem. at 17) whereas here the Preferred Trust Securities were offered in and purchased from California. In *In re Activision Sec. Litig.*, 621 F. Supp. 415, 431 (N.D. Cal. 1985), the court certified a nation-wide class of investors who (like F&C) purchased in the initial stock offering, but refused to certify a nationwide class of investors who purchased after the initial offering (secondary market purchasers) unless they purchased in California. F&C purchased in California and in the initial offering, unlike the Activision shareholders denied claims under the California Corporations Code.

> It should be carefully noted that the definition of offer in Corp. Code Section 25017(b), … will preclude any evasion of the qualification requirements of the statute by transporting the parties across the state border. Any discussions regarding the proposed transaction which have progressed to the point where the parties are ready to [move the closing out of California] for the purpose of consummating the transaction will almost inevitably have involved an offer in this State. Hence the jurisdictional requirements are already satisfied.

Marsh & Volk, *supra* §3.08[4][a]. *See also Eisenbaum v. W. Energy Res.*, 218 Cal. App. 3d 314, 327 (communications from seller in Colorado to buyer in California sufficient to establish an offer to buy or sell in California, and any efforts to waive compliance with the Corporations Code void under §25701); *Hall*, 150 Cal. App. 3d at 417-18 (same).

Finally, were Goldman Sachs able to avoid the reach of California's securities laws simply by delivering the securities through an intermediary in New York, this would effectively act as a unenforceable choice-of-law provision seeking to evade a California statute and contrary to California's stated public policy interest in protecting the public from fraud and deception in securities transactions. *See*, *e.g.*, *Gen. Signal Corp. v. MCI Telecommunications Corp.*, 66 F.3d 1500, 1506 (9th Cir. Cal. 1995) (choice of law provision unenforceable if "such application would run contrary to a California public policy or evade a California statute").

b) Goldman Sachs' Reasonable Investigation Defense Raises an Improper Question of Fact

"Neither Corp. Code §25401 nor Corp. Code §25501 requires that the plaintiff allege or prove as part of his or her *prima facie* case that the misstatement or omission by the defendant was made intentionally or negligently." Marsh & Volk, *supra* §14.03[3][a]. *See also Bowden*, 67 Cal. App. 3d at 715-16. As F&C has pleaded a *prima facie* case against Goldman Sachs under §§25401/25501, the Court need not currently consider the question of whether Goldman Sachs was negligent in offering the Preferred Trust Securities.

California Corporations Code §25501, which provides Goldman Sachs with an affirmative defense, states in pertinent part: "Any person who violates Section 25401 shall be liable . . . ., ***unless the defendant proves . . . that the defendant exercised reasonable care and did not know (or if he had exercised reasonable care would not have known) of the untruth or omission***." This affirmative

defense is taken from §12(a)(2) of the Securities Act. Marsh & Volk, *supra* §14.03[3][a]. Whether or not Goldman Sachs "exercised reasonable care" – it did not – is a question reserved for a jury and not appropriately addressed by the Court on a motion to dismiss. *See*, *e.g.*, *In re Software Toolworks Sec. Litig.*, 50 F.3d 615, 621 (9th Cir. 1995) (holding under analogous federal securities law "summary judgment is generally an inappropriate way to decide questions of reasonableness because 'the jury's unique competence in applying the "reasonable man" standard is thought ordinarily to preclude summary judgment'"); Marsh & Volk, *supra* §14.03[3][c] ("Clearly, no mathematical rule can be laid down as to what constitutes reasonable care, since this is a factual question to be determined by the trier of fact in each individual case.").[15]

Even though the "reasonable care" defense is a question for the jury, Goldman Sachs erroneously argues that the Court can dismiss Flaherty & Crumrine's §§25401/25501 claims because, as a matter of law and under the circumstances of this offering, Goldman Sachs exercised "reasonable care." IP Mem. at 19-20. The Court has already sustained analogous claims under §12 of the Securities Act against Goldman Sachs. *WaMu I*, 259 F.R.D. at 508. Goldman Sachs provides the Court with no basis to reverse itself now.

Goldman Sachs argues it cannot be liable for the false Offering Circulars it used to sell the Preferred Trust Securities because it "was under ***no legal duty to investigate***" the veracity of these statements. IP Mem. at 20 (emphasis in original). This is a preposterous interpretation of §§25401/25501. Goldman Sachs cites no authority in which any court has ever granted a motion to dismiss claims under §§25401/25501 on the basis of this affirmative defense.

As a matter of law, there is a duty to speak truthfully and disclose all material facts when offering to sell securities in California. *See* §§25401, 25400(d), 25500. The affirmative defense set forth in §25501 "is substantially taken from Section 12(a)(2) of the Federal Securities Act of 1933."

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[15] *See also In re Enron Corp. Sec. Litig.*, No. H-01-3624, 2005 U.S. Dist. LEXIS 39927, at *83 (S.D. Tex. Dec. 5, 2005) ("the arguments of Goldman Sachs based on due diligence and reliance on financial statements expertised by Arthur Andersen's review are clearly defenses not properly raised to a 12(b)(6) motion; indeed they raise fact issues that may even preclude summary judgment")

Marsh & Volk, *supra* §14.03[3][a]. "[T]he duty of 'reasonable care' stated in Section 12(a)(2) … require[s] some investigation of the facts before statements are asserted to be true." *Id.* at §14.03[3][b]. As a matter of California statutory law, Goldman Sachs had a duty to perform due diligence before selling the Preferred Trust Securities in California.

Goldman Sachs asserts that because "this was a private placement exempted under Rule 144A[,]" Goldman Sachs was under no duty to perform any steps to discover the untrue statements in the Offering Circulars. IP Mem. at 15-16. *See also id*. at 1 ("Plaintiffs grossly misstate the role and obligations of the Initial Purchasers in these ***private*** offerings of securities under Rule 144A, which are exempt from SEC registration and disclosure requirements." (emphasis in original)); *id*. at 10 (same). The fact that the offerings were made pursuant to Rule 144A is irrelevant to F&C's claims under California law. Indeed, Rule 144A expressly states: "***Nothing in this section obviates the need for any person to comply with any applicable state law relating to the offer or sale of securities***." 17 C.F.R. §230.144A Preliminary Note 5. Any exemption from federal registration requirements did not obviate Goldman Sachs' obligation to comply with California's Corporations Code.

Goldman Sachs' reliance upon *Northwestern Mut. Life Ins. Co. v. Banc of Am. Sec. LLC*, 254 F. Supp. 2d 390, 401 (S.D.N.Y. 2003) is misplaced. IP Mem. at 8, 10, 12, 16, 20. *Northwestern* concerned a Rule 144A private offering in which plaintiffs sued under Wisconsin law only, not California law.

In addition, as a matter of accepted industry practice, Goldman Sachs was obligated to perform some investigation of the truth of the statements in the Offering Circulars. Georgetown law professor, and testifying expert (on behalf of the underwriters) in the *Enron* and *WorldCom* securities litigations, Robert J. Haft has written: "The first is perhaps the most basic principle: ***Perform appropriate due diligence for every offering regardless of whether it is registered or not***. … ***The director or underwriter cannot blindly rely on the truthfulness of information supplied by the issuer***." Robert J. Haft, *Due Diligence in Securities Transactions*, §2.01, at 2-1 (West Group 1999-2001) (Thorpe Decl., Ex. B). "A due diligence investigation is ***a critical component*** in an initial purchaser's decision whether to undertake an offering [pursuant to Rule 144A], enabling the prospective purchaser to

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

evaluate the relevant legal, business, and reputational risks." Lloyd S. Harmetz, *Frequently Asked Questions About Rule 144A*, Morrison & Foerster LLP (2009) (Thorpe Decl., Ex. C) at 14.[16]

Finally, Goldman Sachs was clearly in a position to observe blatant "red flags" indicating the Offering Circulars contained false and misleading statements, making any reliance upon management's representations unreasonable. *See* ¶¶115-42.[17] As the affirmative defense set forth in §25501 is substantially taken from §12(a)(2) of the Federal Securities Act, federal case law is instructive: "Where red flags appear, the underwriter must 'look deeper and question more' in its due diligence investigation. 'The existence of red flags can create a duty to investigate ***even audited financial statements***.'" *Enron*, 2005 U.S. Dist. LEXIS 39927, at *81 (collecting cases). Here, Goldman Sachs' obligation to investigate is even stronger, because Defendants' false statements were not confined to WaMu's audited (*i.e.*, expertised) financial statements. Whether or not Goldman Sachs "exercised reasonable care" in investigating the truth of the Offering Circulars is not a question that the Court can answer on the face of the Amended Complaint.[18]

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[16] *See also Enron*, 2005 U.S. Dist. LEXIS 39927 *82 (""'Tacit reliance on management assertions is unacceptable; the underwriters must play devil's advocate'" and demonstrate a "high degree of care in investigation and independent verification of the company's representations.'"" (collecting cases)).

[17] For instance, Goldman Sachs underwrote over $10 billion in MBSs backed by WaMu subprime loans, and Goldman Sachs had a duty to review WaMu's loan data and quality control random testing of compliance with underwriting – which would have indicated WaMu's loans were not originated pursuant to WaMu's underwriting standards. ¶¶123-125. Furthermore, Goldman Sachs knew internally that subprime and other non-conforming loans – like those on WaMu's balance sheet – were substantially overvalued and the mortgage market would soon correct, exposing WaMu to significant credit and enterprise risk. ¶¶126-141.

[18] The Initial Purchaser Defendants' arguments that they "disclaimed" liability for the veracity of the Offering Circulars, and that F&C's reliance was unreasonable in light of the disclaimers (IP Mem. at 16), are irrelevant to the analysis under §§25401/25501. Goldman Sachs does not raise these issues in seeking to dismiss the §§25401/25501 claims. Accordingly, F&C responds to these issues in §§V.C.2.b. and V.C.2.c, *infra*.

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

2. The Officer Defendants Are Liable for Materially Assisting Goldman Sachs Pursuant to California Corporations Code §25504.1

Flaherty & Crumrine's Sixth Cause of Action states a claim pursuant to §25504.1 against the Officer Defendants for materially assisting Goldman Sachs' violation of §25401. *See* ¶285. Other than incorporating by reference Goldman Sachs' argument with regard to the primary violation under §25401, the Officer Defendants do not move to dismiss the allegations pursuant to §25504.1. *See* OD Mem. at 8-9.

"'Section 25504.1 of the Act provides that any person who "materially assists" in a violation of section 25401, "with intent to deceive or defraud, is jointly and severally liable with any other person liable" for the violation.'" *Collins v. Winex Invs., LLC*, No. 08 CV 51-L (CAB), 2009 U.S. Dist. LEXIS 25553, at *15 (S.D. Cal. Mar. 27, 2009). The Officer Defendants need not have actually participated in the drafting of the Offering Circulars to be liable under §25504.1. *Apollo Capital Fund LLC v. Roth Capital Partners, LLC*, 158 Cal. App. 4th 226, 255-57 (2007).

Flaherty & Crumrine more than sufficiently pleads that the Officer Defendants "materially assisted" Goldman Sachs' violation of §25401 with "intent to deceive or defraud." *See* §III. Indeed, because the Officer Defendants only move to dismiss the §25504.1 cause of action on the grounds that Goldman Sachs did not commit the predicate violation under §25401, and Flaherty & Crumrine pleads a claim against Goldman Sachs (*see* §V.B.1.), the Officer Defendants' motion should be denied.

3. The Officer Defendants Violated California Corporations Code §§25400/25500

Section 25400(d) prohibits the making of a "statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or which omitted to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, and which he knew or had reasonable ground to believe was so false or misleading." Section 25500 provides investors with a private right of action to recover civilly from violators of §25400(d). "The very purpose of these statutes [§§25400/25500] is to 'afford the victims of securities fraud with a remedy without the formidable task

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

of proving common law fraud.'" *Mirkin v. Wasserman*, 5 Cal. 4th 1082, 1102 (1993). "'There is no requirement under these sections [§§25400/25500] that the plaintiff rely upon the statements or acts of the defendant or even that he be aware that the defendant made them or engaged in them.'" *Id*. at 1103.

"The principal limitation of section 25400(d) as a general remedy for securities fraud appears to be the requirement that the party making the misrepresentation be a 'broker-dealer or other person selling or offering for sale or purchasing or offering to purchase the security.' To satisfy this requirement, the plaintiff must prove that ***the defendant was engaged in market activity*** at the time of the misrepresentations." *Mirkin* 5 Cal. 4th at 1123. Simply selling one's own shares in the market satisfies the requirement that the defendant was "engaged in market activity." *Id*.

In *StorMedia Inc. v. Superior Court*, 20 Cal. 4th 449 (Cal. 1999), the California Supreme Court held that where a company sold common stock through an employee purchase plan, even though the sales were not on the open market or made to the plaintiffs in the action, the "seller" requirement of §25400(d) was satisfied.

The Officer Defendants move to dismiss F&C's Fifth Cause of Action under §§25400/25500, asserting "Plaintiffs have not alleged that the WaMu Officers sold, bought, or offered to sell or buy any securities, and therefore, Count Five fails to state a claim." OD Mem. at 8. The Court may take judicial notice of the undisputed fact, as set forth in SEC filings signed by the Officer Defendants, that the Officer Defendants sold WaMu securities and therefore were engaged in market activity sufficient to satisfy the "seller" requirement of §25400(d). Defendants Killinger, Casey, Rotella, Cathcart and Schneider each sold Washington Mutual shares in 2006 and 2007. *See* Thorpe Decl. Ex. D.

C. F&C Properly Pleads Additional California State Law Claims

1. The Officer Defendants Are Liable for Common Law and Statutory Fraud

The elements of common law fraud are: (i) a misrepresentation, which may include false representation, concealment or nondisclosure; (ii) knowledge of falsity (scienter); (iii) intent to defraud, *i.e.*, to induce reliance; (iv) justifiable reliance; and (v) damage to the plaintiff. *Alliance Mortgage Co.*

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

v. Rothwell, 10 Cal. 4th 1226, 1239 (1995).[19] The Officer Defendants' only argument to dismiss the California fraud claims, that F&C fails to plead reliance (*see* OD Mem. at 4-5), is without basis. *See supra*, §V.A.1.

2. All Defendants Are Liable for Negligent Misrepresentation

"The elements of negligent misrepresentation are (1) the misrepresentation of a past or existing material fact, (2) without reasonable ground for believing it to be true, (3) with intent to induce another's reliance on the fact misrepresented, (4) justifiable reliance on the misrepresentation, and (5) resulting damage. In contrast to fraud, negligent misrepresentation does not require knowledge of falsity. A defendant who makes false statements "'honestly believing that they are true, but without reasonable ground for such belief, … may be liable for negligent misrepresentation.'"" *Apollo*, 158 Cal. App. 4th at 243.

As "the complaint states a claim for fraud against [the Officer Defendants] based on the affirmative oral [and written] representations[,] necessarily means it states a claim for negligent

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[19] F&C also asserts claims pursuant to California Civil Code §§1709 and 1710 for deceit. California Civil Code §1709 provides:

> Fraudulent Deceit. One who willfully deceives another with intent to induce him to alter his position to his injury or risk, is liable for any damage which he thereby suffers.

California Civil Code §1710 provides:

> Deceit, What. A deceit, within the meaning of the last section, is either:
>
> 1. The suggestion, as a fact, of that which is not true, by one who does not believe it to be true;
>
> 2. The assertion, as a fact, of that which is not true, by one who has no reasonable ground for believing it to be true;
>
> 3. The suppression of a fact, by one who is bound to disclose it, or who gives information of other facts which are likely to mislead for want of communication of that fact; or
>
> 4. A promise, made without any intention of performing it.

In particular, §1710(2) is a cause of action for deceit through negligent misrepresentation, and does not require scienter or intent to defraud. *See Small v. Fritz Cos.*, 30 Cal. 4th 167, 173-74 (2003).

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2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

representation." *Apollo*, 158 Cal. App. 4th at 243-44. Again, the Officer Defendants' only argument for dismissal of the negligent misrepresentation claims, that F&C fails to plead reliance (*see* OD Mem. at 4-5), is without merit. *See supra,* §V.A.1.[20]

a) The Director Defendants Are Liable for the False and Misleading Statements Attributable to Them

F&C pleads the Director Defendants negligently authorized the sale of the Preferred Trust Securities pursuant to false and misleading offering circulars and negligently made false and misleading statements included in the 2006 and 2007 Offering Circulars, including statements contained in WaMu's Form 10-K filings ***signed by the Director Defendants*** and incorporated by reference in the Offering Circulars. ¶¶45, 143, 146, 176, 184. The Director Defendants move to dismiss asserting the Amended Complaint fails to allege the Director Defendants' role in drafting the false and misleading statements at issue, and that F&C relies upon the discredited group pleading doctrine. DD's Mem. at 10-12. The Director Defendants misstate the law.

In the Ninth Circuit, "***directors who sign or prepare financial disclosures can be held liable for misstatements and omissions therein***." *In re Zoran Corp. Derivative Litig.*, 511 F. Supp. 2d 986, 1011 (N.D. Cal. 2007). *See also In re Maxim Integrated Prods.*, 574 F. Supp. 2d 1046, 1063 (N.D. Cal. 2008) ("A director who signs a financial disclosure may be held liable for any misrepresentations in the

[20] The Director Defendants similarly move to dismiss the negligent misrepresentation claim for lack of reliance. DD Mem. at 12-14. F&C, however, actually read and relied upon the false and misleading statements, and pleads the "who, what, when, and where" of each statement relied upon and which is alleged to be false and misleading. *See, e.g.,* ¶¶24, 143-219, 271. The Director Defendants' cases are inapposite. In *Neubronner v. Milken*, 6 F.3d 666, 673 (9th Cir. 1993), the court found reliance had not been properly pleaded because the plaintiff had purchased common stock, but the allegedly false prospectus concerned "an offering of convertible debentures in which he did not invest, and which was distributed a full year before he purchased any [common] shares. Moreover, he does not state the content of any allegedly false and misleading statements . . . . " *Id*. Whereas the cursory allegation of reliance in *Neubronner* was easily rejected as both unsupported and contrary to common sense, the Director Defendants' argument here – that professional investment adviser F&C did not read the Offering Circulars and WaMu's SEC filings before purchasing the Preferred Trust Securities – is both contrary to the well-pleaded allegations and irrational. *Cadlo v. Owens-Illinois, Inc.*, 125 Cal. App. 4th 513 (2004) concerned injuries suffered as a result of asbestosladen insulation, and the plaintiff had "not alleged that Anthony Cadlo was actually aware of, or was reassured by and relied on this misrepresentation when undertaking work in the presence of Kaylo dust." *Id*. at 520. Here, unlike in *Cadlo*, F&C has pleaded it was aware of and relied upon Defendants' false and misleading statements.

disclosure."). "[S]igners of documents should be held responsible for the statements in the document. … '[T]he affixing of a signature is not a mere formality, but rather signifies that the signer has read the document and attests to its accuracy.'" *Howard v. Everex Sys*., 228 F.3d 1057, 1061 (9th Cir. 2000) (directors who sign SEC filings are liable as primary violators of the securities laws for false statements contained therein).

In effect, the Director Defendants are asserting that they did not "make" or "create" the statements contained in the Form 10-K filing they signed. DD Mem. at 10 ("plaintiffs do not allege that the Outside Directors played any role in the creation of the Forms 10-K"). Not true. A "director signing a document filed with the SEC … ***"makes or causes to be made"*** the statements contained therein." *Howard*, 228 F.3d at 1061.

The Director Defendants set up a straw man by incorrectly asserting F&C relies on the group published doctrine. F&C does not rely on the doctrine at all. In the cases cited by the Director Defendants, such as *Wojtunik v. Kealy*, 394 F. Supp. 2d 1149 (D. Ariz. 2005), the plaintiff relied "on the 'group pleading' or 'group publishing' doctrine to support both the particularity ***and scienter*** aspects of the Amended Complaint." *Id*. at 1163. F&C does ***not*** have to establish the Director Defendants acted with scienter, and has adequately pleaded that the Director Defendants "made" the statements in the Form 10-Ks by signing those documents. *See, e.g., In re LDK Solar Sec. Litig.*, No. C 07-05182 WHA, 2008 U.S. Dist. LEXIS 80717, at *25 (N.D. Cal. Sept. 24, 2008) (collecting cases and holding: "The mere signing of a prospectus or other SEC filing does not, of course, alone establish scienter, but it does establish that the individual made or approved the allegedly false statement."). The Director Defendants may be found liable for the statements in the Form 10-Ks they signed.

Finally, the Director Defendants argue F&C does "not allege that the Outside Directors played any role in the creation, review or approval of the Offering Circulars." DD Mem. at 9. This is not true. *See* ¶45 (directors authorized the sale of the notes pursuant to the Offering Circulars).[21] The Director

[21] Defendants would have this Court reach the absurd, and unsupported, conclusion that WaMu issued the $2.25 billion in Preferred Trust Securities ***without*** the approval and authorization of its board of directors and the finance and audit committees tasked with oversight of such activities. ¶¶108-112.

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

Defendants cite only one authority – *In re Nat'l Century Fin. Enters., Inv. Litig.*, 504 F. Supp. 2d 287, 297-98 (S.D. Ohio 2007) – for the proposition that "courts have declined to assume that outside directors are responsible for the contents of offering documents." DD Mem. at 10. The Director Defendants misstate the holding of *Nat'l Century*. While the court held that plaintiff "MetLife's Section 10(b) [fraud-based] claim against the Outside Directors must be dismissed[,]" the court also held "MetLife's complaint sufficiently states a claim for negligent misrepresentation [against the Outside Directors.]" *Nat'l Century*, 504 F. Supp. 2d at 300, 324. As F&C brings negligent misrepresentation claims against the Outside Directors (not §10(b) fraud claims), *Nat'l Century* supports upholding F&C's Amended Complaint.

b) F&C Justifiably Relied Upon the Initial Purchasers' Statements in the Offering Circulars; "Disclaimers" Do Not Shield the Initial Purchasers from Liability

F&C read and relied upon the Initial Purchaser Defendants' false and misleading statements in the Offering Circulars. ¶¶24, 50, 271. Notwithstanding the requirement that the Court accept as true the factual allegations in the Amended Complaint, the Initial Purchaser Defendants assert they cannot be liable for the false and misleading Offering Circulars because "all of the purported misstatements upon which Plaintiffs relied were provided by WaMu, not the Initial Purchasers." IP Mem. at 16. In contrast, the Amended Complaint clearly pleads the Initial Purchasers "participated in the review and drafting of the Offering Circulars, approved the final Offering Circulars, solicited sales of the Offerings," and "negligently failed to disclose" the truth concerning WaMu. ¶¶115, 142. *See also* ¶50. In support of their dubious contention, the Initial Purchaser Defendants referthe Court to disclaimers in the Offering Circulars that purport to limit the Initial Purchaser Defendants' liability for false and misleading statements. IP Mem. at 16-17. These disclaimers are void as a matter of California law, and courts have repeatedly and thoroughly rejected nearly identical self-serving provisions.

Negligent misrepresentation is a "form of deceit," *Bily v. Arthur Young*, 3 Cal. 4th 370, 407 (1992), liability for which the Initial Purchaser Defendants cannot escape via a boilerplate disclaimer. California law rejects the efficacy of disclaimers, such as those at issue here, in which a party seeks to

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

avoid liability for deceit claims. California Civil Code §1668 states: "[A]ll contracts which have for their object, directly or indirectly, to exempt anyone from responsibility for his own fraud … or violation of law, ***whether willful or negligent***, are against the policy of the law." Similarly, the California Corporations Code imposes upon sellers of securities an obligation to make truthful, complete disclosures of material facts – an obligation that cannot be waived by a disclaimer. *See* §25701 ("Any condition, stipulation or provision purporting to bind any person acquiring a security to waive compliance with any provision of this law … is void.").

Numerous courts have refused to limit the liability of initial purchasers in Rule 144A offerings based upon the existence of boilerplate disclaimers in offering documents. In *IDS Bond Fund, Inc. v. Gleacher NatWest Inc.*, No. 99-116 (MJD/JGL), 2002 U.S. Dist. LEXIS 4073, at *20-*25 (D. Minn. Mar. 6, 2002), the initial purchaser moved for summary judgment because a disclaimer in the offering memorandum (or "OM") disclaimed responsibility for the accuracy or completeness of information in the document. The court rejected that argument, holding that the defendant "is an initial purchaser, and … may be held liable for the alleged misrepresentations or omissions in the OM." *Id.* at *22. Other courts to address the issue are in accord. *See In re Nat'l Century Fin. Enters*., 541 F. Supp. 2d 986, 1004-05 (S.D. Ohio 2007) (rejecting contention "no reasonable investor could have relied on any misrepresentations in the offering materials after seeing the disclaimers" and noting "the disclaimer stating that Credit Suisse had done no independent investigation would seem beyond credulity to potential investors"); *OCM Principal Opportunities Fund, L.P. v. CIBC World Markets Corp*, 157 Cal. App. 4th 835, 867 (2007) (upholding jury verdict against initial purchasers of Rule 144A offering and holding "We are not persuaded that these disclaimers precluded reasonable reliance as a matter of law."); *Gabriel Capital v. Natwest Fin., Inc.*, 94 F. Supp. 2d 491, 501-503 (S.D.N.Y. 2000) (rejecting initial purchaser disclaimer defense).

The Initial Purchaser Defendants incorrectly rely upon the holding in *M&T Bank Corp. v. Gemstone CDO VII, Ltd*., 891 N.Y.S. 2d 578, 581 (N.Y. App. Div. 2009). *See* IP Mem. at 16-17. In *M&T Bank Corp*., the court dismissed certain causes of action because "[e]ssential to each of those causes of action is the existence of ***a special relationship of trust or confidence*** and there is no such

special relationship in this case, particularly in light of the facts that the parties had no relationship prior to this arms-length transaction and that [the] offering circulars contained the various limitations and disclaimers." 891 N.Y.S. 2d at 581.[22] Here, F&C's negligent misrepresentation claims are under California common law (not New York common law), and California does not require the "existence of a special relationship of trust or confidence" to state a claim for negligent misrepresentation. The disclaimers are of no relevance under California common law. *M&T Bank Corp* is inapposite.[23]

c) The Initial Purchasers Had No Reasonable Grounds to Believe the Statements in the Offering Circulars to be True

As set forth in §IV, F&C's claims against the Initial Purchaser Defendants do not sound in fraud. Nonetheless, even under Rule 9(b), "[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally." Whether Defendants did or did not have reasonable grounds for believing their false and misleading statements goes to Defendants' "state of mind." *See*, *e.g.*, *Platt Elec. Supply, Inc. v. EOFF Elec., Inc.,* 522 F.3d 1049, 1055 (9th Cir. 2008) ("without reasonable ground for such belief" element of negligent misrepresentation is the "state of mind" requirement). Accordingly, even assuming the application of Rule 9(b), F&C may simply make a general aversion that the Defendants did not have reasonable grounds to believe their false and misleading statements to be true. F&C clearly pleads this element of its claim. *See*, *e.g.*, ¶¶119, 269.

The Initial Purchaser Defendants argue: "Plaintiffs' negligent misrepresentation claim must be dismissed, because it does not plead ***with particularity*** that the Initial Purchasers made statements ***without a reasonable ground for believing*** them to be true." IP Mem. at 14. There is no requirement

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[22] *See also Wright v. Selle*, 811 N.Y.S. 2d 525, 527 (4th Dep't 2006) (New York common law negligent misrepresentation requires "a special relationship of trust or confidence, which creates a duty for one party to impart correct information to another").

[23] Similarly, *Northwestern*, 254 F. Supp. 2d at 401, is inapposite in that it concerned Wisconsin law only, not California law. *Bily*, 3 Cal. 4th at 402-03, 409, deals with the scope of auditor liability, and says nothing about an initial purchaser's liability for selling securities to investors pursuant to a false and misleading offering circular. The Initial Purchaser Defendants cite no authority in which a seller of securities, in California and pursuant to false statements, was able to avoid liability on the basis of a disclaimer.

that F&C plead the Initial Purchaser Defendants' state of mind with particularity. The Initial Purchaser Defendants cite no authority imposing such a requirement. For instance, *Landmark Screens, LLC v. Morgan, Lewis & Bockius LLP*, No. C 08-2581 JF (HRL), 2008 U.S. Dist. LEXIS 87646, at *22-*23 (N.D. Cal. Oct. 2, 2008) – an unpublished opinion in which negligent misrepresentation was not a claim, but which the Initial Purchaser Defendants cite as if the case addresses negligent misrepresentation specifically (IP Mem. at 14) – stands for the uncontroversial proposition that fraud claims must comply with Rule 9(b). Rule 9(b) does not require pleading the mental state of a negligent misrepresentation claim with particularity.

The Initial Purchaser Defendants' "reasonable grounds" argument concerns an issue typically reserved for the jury, and should not be addressed on the present factual record. *See*, *e.g.*, *Edelstein v. Ryland Corp*., No. 95-56349, 1997 U.S. App. LEXIS 8123, at *5 (9th Cir. Apr. 18, 1997) (defendants' "state of mind" for negligent misrepresentation claims "'are generally factual issues inappropriate for resolution by summary judgment'").

Finally, the Initial Purchaser Defendants argument contradicts the well-pleaded facts. F&C pleads in great detail that the Initial Purchaser Defendants had access to extensive quality control reports detailing adherence to WaMu's underwriting standards (¶¶101-106), the Initial Purchaser Defendants reviewed and had access to the loan documents underlying billions of dollars of WaMu MBSs underwritten by the Initial Purchaser Defendants (¶¶123-124), and the Initial Purchaser Defendants (particularly Goldman Sachs) were writing down the value of subprime loans (like those on WaMu's balance sheet) as the Initial Purchaser Defendants knew these loans were highly overvalued (¶¶126-141). Had the Initial Purchaser Defendants performed any reasonable due diligence and not ignored blatant red flags, the true but undisclosed facts would have been readily apparent to them. ¶119.

D. Flaherty & Crumrine Suffered a Legally Cognizable Economic Loss

F&C's substantial investment in the Preferred Trust Securities is now practically worthless. ¶16. Defendants' false and misleading statements, including those made by the Initial Purchaser Defendants, caused F&C to suffer the loss of its investment. ¶¶240-244. Defendants' false and

misleading statements concealed WaMu's true financial condition and creditworthiness and, by doing so, artificially inflated the price of the Preferred Trust Securities. Defendants' false and misleading statements concealed factors concerning the material risk that WaMu's financial condition would be materially weakened and/or WaMu would be rendered bankrupt as a result of its undisclosed risky lending practices, false appraisals and inadequate reserves for loan losses. These undisclosed material risks materialized, causing the market value of the Preferred Trust Securities to plummet to zero to the detriment of Plaintiffs. ¶242.

In California, "[t]ort damages are awarded to fully compensate the victim for all the injury suffered. There is no fixed rule for the measure of tort damages under California Civil Code section 3333. The measure that most appropriately compensates the injured party for the loss sustained should be adopted." *Santa Barbara Pistachio Ranch v. Chowchilla Water Dist.*, 88 Cal. App. 4th 439, 446-47 (2001). Indeed, a defrauded purchaser is entitled to recover the difference between the actual value of the security at the time of the purchase and the value it would have had if the security had been as represented.[24] *Phelps v. A.L. Jameson & Co.*, 6 Cal. App. 2d 546, 548 (1935) ("Without question the proper measure of damages to be applied in an action to recover damages resulting from fraudulent representations in a sale or exchange of property is the difference between the actual value of the property purchased or received in exchange and the value it would have had had the property been as represented."). Indeed, damages are extremely broad in California and include an award for ***all harm*** that the defendant was a ***substantial factor*** in causing, even if the particular harm could not have been anticipated. *See, e.g.*, *Walker v. Signal Cos., Inc.*, 84 Cal. App. 3d 982, 995 (1978) (damages for fraud are an "amount which will compensate for ***all the detriment caused thereby, whether it could have been anticipated or not***"); 1-1900 CACI 1923 & 1924.

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[24] This same standard applies to F&C's negligent misrepresentation claims. *Garcia v. Superior Court*, 50 Cal. 3d 728, 745 (1990) (causation and damage elements of negligent misrepresentation claim are derived from the same rules governing fraud) (citing 5 B.E. Witkin, *Summary of Cal. Law: Torts* §721, at 819-21 (9th ed. 1988)).

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

Under §§25401/25501, F&C is entitled to a specific statutory measures of damages (which, as set forth *supra*, at §V.B.1, does not require proof of loss causation), that is contrary to the Initial Purchaser Defendants' arguments here. Section 25501 provides that "[a]ny person who violates Section 25401 shall be liable to the person who purchases a security from him or sells a security to him, who may sue either for rescission or for damages (if the plaintiff or the defendant, as the case may be, no longer owns the security)." The measure of recoverable damages "shall be an amount equal to the difference between (a) the price at which the security was bought plus interest at the legal rate from the date of purchase and (b) the value of the security at the time it was disposed of by the plaintiff plus the amount of any income received on the security by the plaintiff."

Despite this clear authority, the Initial Purchaser Defendants incredibly request that the Court dismiss F&C's claims for negligent misrepresentation and violations of §25401 because Plaintiffs "do not allege that they did not receive any required payment from their Trust Securities while they owned them." IP Mem. at 24.[25] The Initial Purchaser Defendants offer no legal authority to support their argument that damages under California law are limited to loss of distribution payments, rather than (i) the difference between the purchase price of the Preferred Trust Securities and their actual value, or (ii) rescission. Indeed, the Initial Purchasers' argument is contrary to the clear language of §25401. Further, California common law holds just the opposite, and has for more than 75 years. *See Housley v. City of Poway*, 20 Cal. App. 4th 801, 812 (1993) (one defrauded in the purchase, sale or exchange of property is entitled to recover the difference between the actual value of that which the defrauded person parted and the actual value of that which he received); *Kendrick v. Schwartz*, 69 Cal. App. 2d 171, 175 (1945) (holding that "one who is defrauded in the purchase of property is entitled to recover 'the difference between the actual value of that with which the defrauded person parted and the actual value of that which he received'"); *Zinn v. Ex-Cell-O Corp.*, 24 Cal. 2d 290, 297(1944) (holding that the measure of damages for fraudulent procurement or sale of capital stock was the difference in actual

[25] Furthermore, the Initial Purchaser Defendants' argumentignores the fact that F&C's Preferred Trust Securities were converted into worthless Washington Mutual, Inc. preferred stock, without the benefits of any distributions, upon WaMu's bankruptcy filing. ¶16.

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

value between what stockholders received and what the shares were in fact worth);*Dyer v. Hunter*, 133 Cal. App. 267, 269-70 (1933) (same); *Pourroy v. Gardner*, 122 Cal. App. 521, 533 (1932) (same).

Additionally, the Initial Purchaser Defendants misconstrue F&C's allegations as a "speculative injury" seeking damages "for an increase in the risk that the securities will not perform in the future." IP Mem. at 24. However, the Initial Purchaser Defendants concede that F&C "allege that the 'market value of the 2006 and 2007 Preferred Trust Securities declined' and that they purchased the Trust Securities at 'artificially inflated' prices" – the very same purchase price inflation measure of damages expressly endorsed under California law. IP Mem. at 24, (quoting ¶¶241-42).[26]

Accordingly, the Initial Purchasers Defendants' motion should be denied with respect to their economic loss argument.

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[26] The Initial Purchaser Defendants' cases are inapposite. IP Mem. at 24 n.15. Neither *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763 (2d Cir. 1994), nor *Luminent Mortgage Capital, Inc. v. Merrill Lynch & Co.*, 652 F. Supp. 2d 576 (E.D. Pa. 2009), address damages under California law. In addition, *First Nationwide Bank* only stands for the unremarkable presumption that a plaintiff cannot recover when "actual damages it will suffer, if any, are yet to be determined." 27 F.3d at 768. Likewise, in *Luminent Mortgage Capital*, the plaintiff only alleged a loss it "***might***" suffer rather than losses it "'actually ***did***'" suffer. 652 F. Supp. 2d at 591. This is not the case here.

Dietrich Siben Thorpe LLP
2173 Salk Avenue, Suite 250, Carlsbad, CA 92008
Tel.: (760) 579-7368 Fax: (760) 579-7369

VI. CONCLUSION

For all of the foregoing reasons, Defendants' motions should be denied in their entirety.[27]

DATED: April 7, 2010

Respectfully submitted,

DIETRICH SIBEN THORPE LLP

By: */s/ David A. Thorpe*

David A. Thorpe
Edward P. Dietrich
Matthew P. Siben
2173 Salk Avenue, Suite 250
Carlsbad, CA 92008
Tel.: (760) 579-7368
Fax: (760) 579-7369
Email: david@dstlegal.com
edward@dstlegal.com
matthew@dstlegal.com

Attorneys for Plaintiffs Flaherty & Crumrine Preferred Income Fund Incorporated, Flaherty & Crumrine Preferred Income Opportunity Fund Incorporated, Flaherty & Crumrine/Claymore Preferred Securities Income Fund Incorporated, Flaherty & Crumrine/Claymore Total Return Fund Incorporated, and Flaherty & Crumrine Investment Grade Fixed Income Fund

[27] The allegations in the Complaint should be upheld; however, if for any reason the Court should deem the allegations lacking, F&C respectfully requests leave to amend the Complaint. *See* Fed. R. Civ. P. 15(a) (leave to amend "shall be freely given when justice so requires"); *Eminence Capital, LLC v. Aspeon, Inc.*, 316 F.3d 1048, 1051 (9th Cir. 2003) (leave to amend should be granted liberally).

CERTIFICATE OF SERVICE

I hereby certify that on April 7, 2010, I filed the foregoing with the Clerk of the Court using the CM/ECF system, and served all parties via ECF.

DATED: April 7, 2010

DIETRICH SIBEN THORPE LLP

By: */s/ David A. Thorpe*

David A. Thorpe
Edward P. Dietrich
Matthew P. Siben
2173 Salk Avenue, Suite 250
Carlsbad, CA 92008
Tel.: (760) 579-7368
Fax: (760) 579-7369
Email: edward@dstlegal.com
matthew@dstlegal.com
david@dstlegal.com

Attorneys for Plaintiffs Flaherty & Crumrine Preferred Income Fund Incorporated, Flaherty & Crumrine Preferred Income Opportunity Fund Incorporated, Flaherty & Crumrine/Claymore Preferred Securities Income Fund Incorporated, Flaherty & Crumrine/Claymore Total Return Fund Incorporated, and Flaherty & Crumrine Investment Grade Fixed Income Fund